FRBSF ECONOMIC LETTER

2015-36 | December 7, 2015

Dancing Days Are Here Again: The Long Road Back to Maximum Employment

BY JOHN C. WILLIAMS

The U.S. economy is on the cusp of full health, supported by highly accommodative monetary policy in recent years. The labor market is nearing maximum employment. Inflation remains too low, but measures of its underlying trend suggest that it is not far from the Fed's 2% target. With real progress toward these goals, the conversation has turned to normalizing policy. The following is adapted from a presentation by the president and CEO of the Federal Reserve Bank of San Francisco to community leaders in Portland, OR, on December 2.

It's that time of year again, a time when all Americans, regardless of faith or origin, participate in a holiday ritual. I'm talking, of course, about the year in review. So in the spirit of the season, I'd like to take a look back over the past year for the economy and monetary policy, to where we find ourselves today, and where I see us headed.

The economic snapshot

The headline is that we're now in the seventh year of the expansion and the economy still has a good head of steam. Consumer spending continues to increase at a solid pace, auto sales should come in at their highest since the early 2000s, and strong fundamentals point to continued strength going forward.

There are some upside risks to the outlook, specifically an even stronger and faster rebound in housing. And there are, of course, downside risks: the threat of slowdowns and spillovers from abroad, or the dollar appreciating further.

And then there are the big issues. The Fed is charged with maximum employment and price stability. Looking over our dual mandate, how have we fared?

Employment

On the employment side, things are going very well.

We're on pace to add about 2½ million jobs this year, and we've met one marker on the unemployment rate. Because unemployment will never be zero—in any healthy economy, there will be turnover, with people leaving jobs and new people entering the workforce—economists use something called the "natural rate" of unemployment. Broadly, it's the optimal rate in a fully functioning economy. I put the natural rate at 5%, and we've already reached that threshold. I expect the unemployment rate to continue to edge down, falling below 5% either this year or next, and stay there until 2017.

Of course, the unemployment rate alone doesn't tell the whole story. There are other factors and measures that reflect the complexities of the American workforce and how people have fared in the aftermath of the recession.

Most discussed—and for many, the most worrisome—is the labor force participation rate, which is still significantly lower than it has been in the past. On the surface, this can appear alarming. But digging deeper it is, by and large, explicable and relatively benign.

As a primer: The "labor force" is made up of people who are either employed or unemployed but actively looking for work. The labor force participation rate divides that group by the total working-age population—that is, everyone over the age of 16. It's a very basic ratio that's affected by myriad factors. In the '60s and '70s, for instance, women entered the workforce in greater numbers and the labor force participation rate shot up.

Since the start of the recession, the participation rate has come down substantially. Some people are concerned that this is indicative of a portion of society that was hit hard by the recession and sidelined in the recovery—people who want to work but have given up looking, either out of pessimism over the job market or fear that an extended time out of work has rendered them fundamentally unemployable.

But much of the decline in the labor force participation rate can be explained not by disheartened workers, but by demographic and social shifts (see, for example, Fujita 2014).

First is the aging of the population. The baby boomers are entering retirement and people are living longer. Remember, the participation rate counts *everyone* over 16, so my happily retired parents count as "out of the labor force," even though, in their 80s, few people would still be working. Second is that younger people aren't working as much as they used to. But this is partly because many have extended their education or gone back to school, and fewer are working when they're there. Third is an increase in people deciding they'd rather have single-income families (Bureau of Labor Statistics 2007–2014). For whatever reason, they've traded a second paycheck for spending more time at home, whether it's for child care, leisure, or simply that it's a better lifestyle fit. Each of these groups is made up of people who are not working, but doing so for personal or demographic reasons. As their numbers swell, it will, obviously, push the participation rate down.

As for the area of concern, we're emerging from the deepest, longest recession since the Great Depression. And it's true that a lot of people did give up looking for work. A key indicator is the somewhat unfairly named "prime-age males" cohort, who are 25–54. This group has historically been a constant in the American workforce, but in the wake of the recession, its participation fell sharply. However, as the labor market has improved, that number has largely stabilized over the past two years, as has the overall participation rate.

The last factor to consider is whether there are people who will reenter the labor force and pull the participation rate back up. The "marginally attached" for instance, a group made up of people who are ready and able to work and who've searched for jobs in the past year but who aren't currently looking. The assumption would reasonably be that this group is poised to return to the labor force. First off, these numbers have come down a lot, falling by over 12% in the past year alone. In addition, my staff has found that, over the past few years, their reentry rate back into the labor force has actually fallen. When you combine this with the aging workforce, it looks unlikely that participation will rise. This is supported by other research from both within and outside the Fed System (Stephanie Aaronson et al. 2014 and Krueger 2015). Overall, the evidence suggests that, even with a quite strong economy, we won't see a significant number of people come back into the fold.

I know this has been a tough journey for a lot of people, and many are still struggling. But putting the recovery in perspective, we've come a very long way and we should be heartened by the progress. Since the dark days of late 2009, we've added 13 million jobs. More than 3 million of those came last year, and most of those were full time.

Looking forward, I see a labor market that's growing ever stronger and will reach maximum employment on a broad set of measures later this year or early next year.

Inflation

The inflation side of the equation is where the winds are blowing colder than I'd like. For those of us who lived through the '70s and '80s, the need for higher inflation seems anathema to a healthy economy, but that's where we are right now. Inflation is like wine—a little bit is actually good for you. And right now our glass isn't full enough. The Fed's target rate is 2%, and inflation has been obstinately below that for 3½ years now. Over the past year, it's been stuck at a little above zero.

There are reasons for the depressed level of inflation, in particular the rise in the dollar and the fall in oil prices. Those effects should peter out, but they've had a downward influence on inflation at a time we've needed it to rise. Another special factor is that health-care prices have been rising much more slowly than we're used to and that's pushing down the inflation rate as well. This is in part due to legislation that holds down payments to hospitals and other providers. These effects may prove to be transitory as well.

I know that people don't always feel the reality of inflation being too low. The average person in a supermarket checkout line probably doesn't. People often ask if Fed officials eat or drive, because we favor inflation measures that strip out food and energy. For the average household, those are obviously important. But for formulating monetary policy and analyzing data, policymakers need to look at underlying trends. That's why I look at measures that remove the volatile components, like the trimmed mean rate that the Dallas Fed came up with. By that measure, we're not as far from our goal as it first appears. The trimmed mean puts the underlying inflation rate for the past year at 1.7%—still below our 2% target, but not by much.

Looking ahead, as the effects of the dollar and oil prices ebb, and as the economy strengthens further, I see inflation moving back up to our 2% target within the next two years.

Monetary policy normalization

With real progress on our goals, the conversation has turned to normalizing policy. That is, raising interest rates. There are a number of opinions out there, many of which wind up in my inbox.... From my perspective, the song remains the same: We've made remarkable progress and the economy is on the cusp of full health. The first step in bringing policy closer to normal was when we ended quantitative easing, or QE. The next appropriate step is to raise rates. My preference is sooner rather than later for a few reasons.

First, Milton Friedman (1961) famously taught us that monetary policy has long and variable lags. Research shows it takes at least a year or two for it to have its full effect (Havranek and Rusnak 2013). So the decisions we make today must take aim at where we're going, not where we are. The economy is a moving target, and waiting until we see the whites of inflation's eyes risks overshooting the mark.

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.

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 to raise rates, 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.

My preference for a more gradual process also reflects that the economy, for all its progress, still needs some accommodation. We don't need the extraordinarily accommodative policy that has characterized the past several years, but the headwinds we're facing—the risks from abroad, for instance, and their impact on the dollar—call for a continued push. Not with a bulldozer, but a steady nudge.

That brings me to another point. Monetary policy has played a crucial role in getting us back on track (Swanson and Williams 2014 and Williams 2014). We're heading towards an economy that's near full strength—we're not quite across the finish line, but it's definitely in sight. As we head towards it, 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 2% inflation and keep it there, using the tools available to us. 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.

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 (Fernald and Jones 2015), by tax policies and long-term fiscal decisions. 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.

New normal

As that decade begins to unfold, 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, 4% 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.

It's not surprising that the pace of employment growth and the decline in the unemployment rate have slowed a bit this year relative to last. When unemployment was at its 10% peak, and as it struggled to come down during the recovery, we needed rapid declines to get the economy back on track. Now that we're getting closer, the pace has to start slowing. In fact, once the economy is operating at full strength, we're only going to need between 60,000 and 100,000 new jobs a month to keep up with the growing labor force (Daniel Aaronson et al. 2014). And as the next year unfolds, we want to see a steady pace of economic growth at around 2%. Commentators may call this disappointing, and it was when we were climbing out of the hole the recession left. But in a healthy economy, it's what strong, steady growth looks like. As I said, running too hot for too long has serious risks.

Conclusion

All in all, things are looking good. We've come a long way since the worst of the recession and made significant progress this year. Going forward, I expect things to continue on this positive trajectory.

This is my last public speech of the year, and I'm very pleased to be doing it in Portland with you all. So I'd like to extend my thanks to you; I'm much obliged for such a pleasant stay.

John C. Williams is the president and chief executive officer of the Federal Reserve Bank of San Francisco.

References

Aaronson, Stephanie, Tomaz Cajner, Bruce Fallick, Felix Galbis-Reig, Christopher Smith, and William Wascher. 2014. "Labor Force Participation: Recent Developments and Future Prospects." *Brookings Papers on Economic Activity*, Fall, pp. 197–255. http://www.brookings.edu/~/media/projects/bpea/fall-2014/fall2014bpea_aaronson_et_al.pdf

Aaronson, Daniel, Luojia Hu, Arian Seifoddini, and Daniel G. Sullivan. 2014. "Declining Labor Force Participation and Its Implications for Unemployment and Employment Growth." FRB Chicago *Economic Perspectives* 38(fourth quarter), pp. 100–138. https://www.chicagofed.org/publications/economic-perspectives/2014/4q-aaronson-etal

Bureau of Labor Statistics. 2007–2014. "Archived News Releases: Employment Characteristics of Families." http://www.bls.gov/schedule/archives/all_nr.htm#FAMEE

Fernald, John G., and Charles I. Jones. 2015. "The Future of U.S. Economic Growth." *American Economic Review* Papers and Proceedings 104(5, May), pp. 44–49.

Friedman, Milton. 1961. "The Lag in Effect of Monetary Policy." Journal of Political Economy 69(5), pp. 447–466.

Fujita, Shigeru. 2014. "On the Causes of Declines in the Labor Force Participation Rate." *Research Rap Special Report*, FRB Philadelphia, revised February 6. https://philadelphiafed.org/research-and-data/publications/research-rap/2013/on-the-causes-of-declines-in-the-labor-force-participation-rate.pdf

Havranek, Tomas, and Marek Rusnak. 2013. "Transmission Lags of Monetary Policy: A Meta-Analysis." *International Journal of Central Banking* 9(4, December), pp. 39–75. http://www.ijcb.org/journal/ijcb13q4a2.htm

Krueger, Alan. B. 2015. "How Tight Is the Labor Market? The 2015 Martin Feldstein Lecture." *NBER Reporter* 2015(3). http://www.nber.org/reporter/2015number3/2015number3.pdf

Swanson, Eric T., and John C. Williams. 2014. "Measuring the Effect of the Zero Lower Bound on Medium- and Longer-Term Interest Rates." *American Economic Review* 104(10, October), pp. 3,154–3,185.

Williams, John C. 2014. "Monetary Policy at the Zero Lower Bound: Putting Theory into Practice." Working paper, Hutchins Center on Fiscal and Monetary Policy at Brookings. http://www.brookings.edu/research/papers/2014/01/16-monetary-policy-zero-lower-bound-williams

Recent issues of *FRBSF Economic Letter* are available at
http://www.frbsf.org/economic-research/publications/economic-letter/

2015-35	Global Fallout from China's Industrial Slowdown http://www.frbsf.org/economic-research/publications/economic-letter/2015/november/global-fallout-from-china-industrial-slowdown	Spiegel
2015-34	What's Different about the Latest Housing Boom? http://www.frbsf.org/economic-research/publications/economic-letter/2015/november/what-is-different-about-latest-housing-boom-mortgage-debt-ratio/	Glick / Lansing / Molitor
2015-33	Are Wages Useful in Forecasting Price Inflation? http://www.frbsf.org/economic-research/publications/economic-letter/2015/november/are-wages-useful-in-forecasting-price-inflation/	Bidder
2015-32	Why So Slow? A Gradual Return for Interest Rates http://www.frbsf.org/economic-research/publications/economic-letter/2015/october/gradual-return-to-normal-natural-rate-of-interest/	Cúrdia
2015-31	The Economic Outlook: Live Long and Prosper http://www.frbsf.org/economic-research/publications/economic-letter/2015/october/economic-outlook-live-long-and-prosper-speech/	Williams
2015-30	Can We Rely on Market-Based Inflation Forecasts? http://www.frbsf.org/economic-research/publications/economic-letter/2015/september/market-based-inflation-forecasting-and-alternative-methods/	Bauer / McCarthy
2015-29	Assessing Supervisory Scenarios for Interest Rate Risk http://www.frbsf.org/economic-research/publications/economic-letter/2015/september/assessing-basel-bank-supervision-scenarios-for-interest-rate-risk/	Christensen / Lopez
2015-28	Measuring Monetary Policy's Effect on House Prices http://www.frbsf.org/economic-research/publications/economic-letter/2015/august/measuring-monetary-policy-effect-on-house-prices-speech/	Williams
2015-27	Residual Seasonality and Monetary Policy http://www.frbsf.org/economic-research/publications/economic-letter/2015/august/residual-seasonality-and-monetary-policy/	Rudebusch / Wilson / Pyle
2015-26	Is China's Growth Miracle Over? http://www.frbsf.org/economic-research/publications/economic-letter/2015/august/china-economic-growth-miracle-slowdown/	Liu
2015-25	Interest Rates and House Prices: Pill or Poison? http://www.frbsf.org/economic-research/publications/economic-letter/2015/august/interest-rates-and-house-prices-central-bank-goals/	Jordà / Schularick / Taylor
2015-24	Assessing the Recent Behavior of Inflation http://www.frbsf.org/economic-research/publications/economic-letter/2015/july/assessing-recent-inflation-behavior-phillips-curve/	Lansing
2015-23	The Recovery's Final Frontier? http://www.frbsf.org/economic-research/publications/economic-letter/2015/july/the-recoverys-final-frontier-economic-outlook-speech/	Williams