

# FRBSF Economic Letter

2017-22 | August 7, 2017 | Research from the Federal Reserve Bank of San Francisco

## Monetary Policy's Role in Fostering Sustainable Growth

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As the economy has transitioned from recovery to expansion, the role of monetary policy has shifted to sustaining the expansion by gradually moving conventional and unconventional policy back to normal. But monetary policy is reaching its limit for stimulating growth, calling for private and public sector investments and policies to step up and take the lead. The following is adapted from a presentation by the president and CEO of the Federal Reserve Bank of San Francisco to the Economic Club of Las Vegas in Las Vegas on August 2.

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This is a critical juncture for the American economy. After years of hardship and struggle, we've managed to recover from the devastating effects of the housing crash, the foreclosure crisis, and the ensuing financial crisis and Great Recession. As the economy has transitioned from recovery to ongoing expansion, the role of monetary policy has shifted from getting America back to work to sustaining the expansion for as long as possible. That means gradually ratcheting back on monetary policy stimulus and trying to keep the economy on an even keel.

But, even as we see daylight in today's economy, we find ourselves in the shadow of daunting longer-term challenges to economic growth and shared prosperity. These include a sea change in demographic factors like slowing population and labor force growth and a downshift in productivity growth.

The theme of my talk is that monetary policy is reaching its limit as to what it can do to generate economic growth. Other actors—in both the private and public sectors—need to step up and take the lead in making the investments and enacting policies needed to improve the longer-term prospects of our economy and society. The outstanding question is whether we as a nation will rise to these challenges and define our economic future, or will we instead allow our economic future to define us.

### The Federal Reserve's goals: A scorecard

The Congress has mandated that our job is to keep the economy stable and on track, with a focus on two big goals: maximum employment and price stability. That means we want everyone who wants a job to be able to find one and for inflation to average 2% per year over the long run.

Today, the U.S. economy is about as close to these goals as we've ever been. Among other things, we've fully recovered from the recession.

When it comes to our employment goal, this is typically viewed in terms of the unemployment rate relative to the natural rate of unemployment—by this I mean the level consistent with an economy that is running neither too hot nor too cold. We can't know precisely where this magic number is, but I put it at about 4¾%.

Today, the U.S. unemployment rate is 4.4%—meaning that we’ve not only reached the full employment mark, we’ve exceeded it. Given the strong job growth we’ve been seeing in the United States, I expect the unemployment rate to edge down a bit further this year and then remain a little above 4% through next year.

Of course, the unemployment rate is only one metric of labor market health. The good news is that we have seen broad-based improvement in the labor market across a broad swath of indicators.

To help provide a broader measure of underemployment, economists at the Federal Reserve have developed a useful summary measure of labor market slack called the Non-Employment Index, or NEI (Hornstein, Kudlyak, and Lange 2014 and Federal Reserve Bank of Richmond 2017). Instead of debating whether or not to include one group or another as part of the “labor force,” they let the data do the talking. The NEI includes all members of the non-working population based on their likelihood of taking a job. It’s currently at the same level as the peak in the labor market back in 2006, providing another clear signal that we have reached a full-employment economy.

While we’ve reached our employment goal, we still have a ways to go in terms of inflation. The Fed’s preferred measure of inflation has been running below our longer-term goal of 2% for quite a while now. In the past, this low rate of inflation was the product of a number of factors—the recession and falling prices of imported goods and services being the two main ones.

In recent months, some special transitory factors—like sharp declines in prescription drug prices, airfares, and especially wireless service fees—have been pulling inflation down. To cut through the noise, it’s helpful to look at measures that strip out prices that fluctuate wildly. My favorite such measure is the trimmed-mean PCE inflation rate reported by the Dallas Fed. Over the past year through May, this measure is at 1.7%. As these transitory factors wane and with the economy doing well, I expect that we’ll reach our 2% goal in the next year or two.

### Transitioning from recovery to sustained expansion

With the economy having reached full employment, the Fed’s job is to keep it there. That means managing the risk that the economy will get too hot and out of balance against the risk that the expansion will stall (Williams 2017b).

During the recession and recovery, jump-starting and speeding the recovery required historically low interest rates. But today, with the recovery already complete, interest rates in the United States are still low.

To keep the economy on a sustainable path of growth, we need to gradually reduce the monetary stimulus put in place during the recession and recovery. If we delay too long, the economy will eventually overheat, causing inflation or other imbalances to emerge. At some point, that would put us in the position of having to quickly reverse course to slow the economy. That risks stalling the expansion and setting us back into recession.

As I said, my goal is to keep the economic expansion on a sound footing that can be sustained for as long as possible. The last thing any of us want is to undermine the hard-won gains we’ve made since the dark days of the recession, when it seemed like the U.S. and world economies were on the verge of collapse.

Therefore, we're in the process of monetary policy normalization. For starters, over the past two years, we've moved interest rates up slowly in line with the improvement in the economy and the economic outlook. Even with those increases, rates remain low. So we've indicated that we expect that economic conditions will warrant further gradual increases in the future (Board of Governors 2017a).

## Shrinking the Fed's balance sheet

I've been talking about what's known as conventional monetary policy—that is, changes in short-term interest rates. We also made use of so-called unconventional policy actions over the past decade that we need to normalize as well.

In response to the recession and slow recovery, the Fed purchased trillions of dollars of long-term Treasury bills and mortgage-backed securities (MBS). By reducing long-term interest rates and stabilizing financial markets during the crisis, the Fed helped the U.S. economy achieve the relatively healthy state that it's in today (Williams 2014 and Engen, Laubach, and Reifschneider 2015).

After making these purchases, we significantly increased the size of the Fed's holdings. Right now, the Fed's balance sheet is \$4.5 trillion. We are currently keeping it at that level by reinvesting the principal payments we receive.

Now that the U.S. economy has fully recovered, the Federal Open Market Committee has said that it intends to gradually reduce these holdings by cutting back on the amount we reinvest every month (Board of Governors 2017b). My own view is that it will be appropriate to start this process this fall.

At the outset, we'll start nice and easy, letting our holdings of Treasury securities decline by \$6 billion a month, and those of MBS by \$4 billion per month. Thereafter, we'll increase these caps by \$6 billion and \$4 billion, respectively, every three months, until they reach \$30 billion per month for Treasuries and \$20 billion per month for MBS. From then on, we'll leave these caps in place, and our securities holdings will continue to decline in a gradual and predictable manner (Board of Governors 2017b).

We'll continue this process of letting the balance sheet gradually shrink until we get to the point that we're holding no more securities than necessary to implement monetary policy efficiently and effectively. It should take about four years to get the balance sheet down to a reasonable size (Federal Reserve Bank of New York 2017). While we haven't settled on what that exact number will be, it will be quite a bit lower than today.

Importantly, this process of shrinking our balance sheet will take place in the background. We will continue to use conventional monetary policy tools—raising or lowering interest rates—as the primary lever we operate to keep the economy from running too hot or too cold (Board of Governors 2017b).

## Sea change in sustainable growth

So far I've focused on what's going well. I'll now shift gears and turn to some of the big challenges that are ahead of us even with the economy at full employment. The big dichotomy of our times is that the economic news is at once both encouraging *and* discouraging: encouraging that the economy is expanding; discouraging that growth is disappointing, at least by historical standards.

In fact, growth of gross domestic product (GDP) has been almost as *unimpressive* as growth in employment has been *impressive*. In the eight years since the recession ended, real GDP growth has averaged only about 2%, well below former trends, while we've added an impressive 15½ million jobs. How can both be true?

As I mentioned at the beginning of my remarks, a sea change in sustainable growth is under way, driven by fundamental shifts in demographics and productivity growth.

Specifically, due to declining birth rates, the retirement of the baby boom generation, and other factors, the labor force is expected to grow only about ½% per year over the next decade (Congressional Budget Office 2017). That's less than one-third the pace of the 1980s.

And productivity growth has slowed markedly from the surge in the mid-1990s and early 2000s. It has averaged only a little over 1% per year since 2005. This slowdown isn't because of some failure of economic statistics to capture the latest breakthroughs in technology (Byrne, Fernald, and Reinsdorf 2016). Nor are there signs of a resurgence as the economy has recovered.

Assuming that these trends continue, and I do, the growth rate of our economy's potential is likely to be around 1.5% for the foreseeable future, the slowest pace in our lifetimes (Fernald 2016). The consequences of slow growth will be felt by monetary, fiscal, and other public policymakers (Williams 2016b, 2017a,c). Unless these trend lines improve, they will likely find that they are repeatedly being asked to do more with less—in some cases much less—than they planned for. Those who fail to act today will find their challenges getting even more severe tomorrow.

### **If not monetary policy, then what?**

This begs the question, what does said action look like? As a monetary policymaker, I wish I could tell you that it's within the purview of central banks to solve all this, that the answer lies in raising or lowering interest rates. Reality, unfortunately, dictates otherwise.

Our long-term challenges are going to require the sorts of long-term investments that fiscal policymakers—and private investors—have within their own toolkits. We know that there is a range of things we currently underinvest in that have very high returns on investment, both for individuals and for nations as a whole. These include early childhood education and health, secondary and higher education, job training, infrastructure, basic research and development ... all the things that propel an economy and prosperity over the longer term (Williams 2016a,b, Fischer 2017).

With the sea change already under way, we no longer have the luxury of taking a wait-and-see approach. These policies and actions may be difficult and costly to implement, but our nation has successfully met such challenges in the past, and I am confident we can again.

### **Conclusion**

To sum up, it's been a long, hard road, but we have finally attained a recovery from the financial crisis and the Great Recession. Because no good deed goes unpunished, monetary policymakers who worked very hard to help our economy recover are now faced with the challenges of protecting what we've gained. Our goal,

therefore, is to foster sustainable growth. This requires bringing both conventional and unconventional monetary policy gradually back to normal.

As I have emphasized, though, there is only so much that monetary policy can do. We face significant longer-term challenges that interest rates alone can't solve. The choices are clear; what remains to be seen is whether the critical investments in our future will be made. These decisions have ramifications that extend beyond the next few months or years—they will define the economic landscape for the next decade and beyond. In a broader sense, they're also about the next generation and what sort of future we choose to create together.

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