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Expecting the Expected: Staying Calm When the Data Meet the Forecasts

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The expansion is proceeding at a good pace, unemployment is low, and inflation is finally headed in the right direction. The data show no signs of an economy going into overdrive. This suggests that further gradual increases in interest rates are likely in 2018, assuming the data continue to come in largely as expected. The following is adapted from remarks by the president and CEO of the Federal Reserve Bank of San Francisco to the Financial Women of San Francisco on February 2.

This is one of my first public speaking engagements of 2018, and I'm very happy to be able to kick off with positive news about the economy. The expansion is now in its ninth year, the stock market is at record levels, and all the key economic indicators are headed in the right direction.

San Francisco is a leading example of the growth we're seeing across the country. Many of the things that drive us crazy about this city—bad traffic, sky-high rents, and sidewalks blocked by construction—are signs of a strong economy. Of course, I blame the gridlock on 101 on all the techies flooding the Bay Area. But it's not just tech that's powering the American economy—far from it.

The really good news about this expansion is that it's taking place nationwide and across the full range of sectors. Consumer spending, manufacturing activity, and construction are all showing strong numbers. And it's part of a global trend of stronger-than-expected growth. Both Europe and Japan have seen a significant acceleration in GDP growth. The International Monetary Fund expects global growth in 2017 will register an impressive 3.7% when the final numbers are in (International Monetary Fund 2018).

With so much momentum, you'd think people would be happy. But no, instead I'm coming across a lot of anxiety about how the Fed's going to respond to such buoyancy. There's a concern that we're either behind the curve or going to have a knee-jerk reaction to all this positivity when it comes to monetary policy.

I was amused to see that, in a Bloomberg article titled "5 Things to Fear in a Strong Global Economy" (Moss 2018), the most terrifying thing was the possibility of a Fed overreaction!

So today I'm going to look at the key economic indicators: growth, employment, and the enigma that is low inflation. I'm going to discuss the evidence, show what's driving the numbers, and assess whether the economy really has shifted into a higher gear. Finally, I'm going to talk about my own view on appropriate monetary policy.

Growth

I've already talked a bit about growth, but there are two questions I want to address now: First, with all the positivity, is the economy taking off far more than expected? And second, given that we're in the third-longest (soon to be the second-longest) expansion in history, are we at risk of recession? Will the expansion die of old age?

The answers to both these questions lie in the data. Growth in 2017 came in at 2.5%. This is a solid performance. Indeed, it's above the trend growth rate, which I peg at about 1¾%. The trend growth rate is the rate of growth that can be sustained over the long term, and it's determined by economic fundamentals like demographics and productivity growth.

I expect the same this year, with growth again coming in at 2.5%. Strong financial conditions, better-than-expected global growth, and the tax cuts have all created tailwinds that can account for the healthy pace of growth. Because of these tailwinds I have boosted my growth forecasts for this year, but I don't see an economy that's fundamentally shifted gear.

Turning to the second question: Will the expansion die of old age? The short answer is no. Recessions don't happen because a timer goes off (Rudebusch 2016). Recessions generally happen because of unanticipated shocks: The global financial crisis of 2008 was caused by the subprime mortgage crisis, the recession of the early 2000s was caused by the dot-com bubble, and the recession of the early 1990s was triggered by the sharp rise in oil prices.

These kinds of shocks are notoriously hard to predict, but they happen for a reason, not because the business cycle has a time limit on it. Given that the pace of growth is somewhat above trend, my view is that we need to continue on the path of raising interest rates. This will keep the economy on an even footing and reduce the risk of us getting to a point where things *could* overheat.

Obviously, growth figures are the ones the media are most focused on. But as President of the San Francisco Fed and a voting member on the Federal Open Market Committee (FOMC), I'm judged on what happens to employment and inflation. The Federal Reserve has a dual mandate of maximum employment and price stability, so my day job is about understanding what's going on with those figures and then making appropriate monetary policy recommendations.

Employment

When it comes to the Federal Reserve's report card on employment, I think it's more than fair that we give ourselves an A grade. We added over two million jobs in 2017, about twice the number needed to keep pace with normal labor force growth (Bidder, Mahedy, and Valletta 2016). During the final three months of 2017, unemployment was an unusually low 4.1% as of January 31. The last time we saw unemployment this low was in the year 2000. These low unemployment numbers have many people asking why we're not seeing greater wage growth, but that number actually has been slowly ratcheting up.

This is consistent with the reports I've been hearing from business leaders for a while. As talent becomes increasingly scarce, they're offering higher wages in a bid to compete for employees. I expect this to intensify as the labor market heats up further.

Inflation

Such economic optimism, coupled with low unemployment, normally would be associated with rising inflation. But I'm afraid our report card here is not so glowing. The Fed has set itself a goal of 2% inflation, a target we have missed more often than not. I spent much of 2017 talking about the enigma of low inflation, why it's occurred, and my expectations for the future. Of course most normal people are very pleased with a strong economy, plentiful jobs, and stable prices. But economists are not so easily satisfied!

One of the fundamentals of economics is the Phillips curve, which describes the relationship between unemployment and inflation. If the Phillips curve is right, when unemployment falls, inflation should rise. Because when unemployment falls, wages go up, which pushes up business costs and should increase consumer demand and, in turn, raise prices. Last year's paltry inflation figures have led many economic commentators to pose the question: Is the Phillips curve dead?

Based on the research of my colleagues at the Fed, the Phillips curve still holds true (Mahedy and Shapiro 2017 and Cúrdia 2018).

I have two main reasons for my confidence. First, last year we saw a number of transitory factors holding down inflation. These included price drops for pharmaceuticals, airline tickets, and cell phone services. An even bigger contribution to low inflation came from the health-care sector, where mandated cuts to Medicare payment growth muted price rises for health-care services. These factors are slowly disappearing from the data. Second, it always takes a while for the effects of low unemployment and a strong economy to translate into higher inflation, with a common delay of about 12 months.

The recent price data have been encouraging in this regard, and I expect that we'll continue to see inflation pick up this year and the next. Fear not, the Phillips curve is alive and will soon be kicking!

Monetary policy

I began by describing a very positive economic outlook of strong growth, low unemployment, and inflation that looks like it's *finally* headed in the direction Fed economists have been hoping for. But despite all this optimism, there's anxiety about how the Federal Reserve is going to react. Will we raise rates too rapidly? Or will we raise rates too slowly because we fail to spot a financial bubble? Both scenarios could knock the expansion off track, and that's the last thing I want to see happen.

I *am* optimistic about the economy, but I expect continued moderate growth, with no Herculean leap forward. So given that the economy's performing *almost* exactly as expected, you can expect policymakers to do the same.

And how should you know what to expect? In the aftermath of the financial crisis the FOMC started issuing clearer guidance about future policy, indicating how policymakers plan to manage interest rates based on the latest data and projections. Last year the Committee signaled the likelihood of further gradual rate increases in 2018, and, as I said earlier, my own view is we should stick to that plan (Board of Governors 2017a, b). It will keep the expansion on track, prevent the economy from exceeding its potential by too much, and get interest rates back up closer to more normal levels.

Policymaking is, by its very nature, a long game. The full effects of a change the FOMC makes today are unlikely to be felt for two years: A knee-jerk reaction would have far-reaching consequences, and my FOMC colleagues and I are well aware of that. My approach is to always follow the data very carefully and then adjust my recommendations accordingly.

And of course, this is where I give a caveat for everything I've said so far by underlining my focus on the data. If actual growth is paltry, or if there are signs of an economy that's growing at an unsustainable rate, or if inflationary pressures are building too fast, then I'll reevaluate my position and advocate for adjusting the path of rates accordingly. But at the moment, while I'm buoyed by the optimism, I don't see an economy at risk of shifting into overdrive.

Conclusion

In conclusion, the outlook is positive: The expansion is proceeding at a good pace, unemployment is low, and inflation is finally headed in the right direction again. Even if most people don't want higher prices, it's a great relief to me that the Phillips curve isn't broken.

But while the outlook is positive, it's not so strong that it's driving a sea change in my position. For the moment, I don't see signs of an economy going into overdrive or a bubble about to burst, so I have not adjusted my views of appropriate monetary policy. So my message to those concerned about a knee-jerk reaction from the Fed is that, as always, we'll keep our focus on the dual mandate and let the data guide our decisions.

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