FRBSF Economic Letter

2018-10 | April 9, 2018 | Research from the Federal Reserve Bank of San Francisco

Supporting Strong, Steady, and Sustainable Growth

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The U.S. economy is on course to be as strong as in many decades, and inflation is moving closer to the Federal Reserve's target. The challenge for monetary policy is to keep it that way. While this is never an easy task, the Fed is well positioned to achieve its goals and respond to unexpected developments. The following is adapted from a speech by the president and CEO of the Federal Reserve Bank of San Francisco to the World Affairs Council of Sonoma in Santa Rosa, CA, on April 6.

I've spent this year so far giving "good news" speeches; talking about the strong economy, the long expansion, and robust job growth. And with good reason: We're in the third – in fact, very soon to be the second – longest economic expansion in American history. We added over two million jobs last year, the unemployment rate is the lowest it's been since 2000, and inflation is closing in on our 2 percent target.

The San Francisco Bay Area is a leading example of the growth we're seeing across the country. Many of the things that drive us crazy—bad traffic, sky-high housing costs, and sidewalks and streets blocked by construction—are signs of a robust economy. It's easy to 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. This healthy expansion is taking place nationwide and across the full range of sectors. And it's part of a global trend of stronger-than-expected growth.

Today, I will continue to accentuate the positive and highlight the reasons I expect the economy will continue to improve, reaching milestones that we haven't seen in nearly 50 years. I'll finish with my views on what this means for monetary policy and how we can keep this economy, strong, resilient, and growing at a steady pace.

What drives sustainable growth?

Last year real gross domestic product, or GDP, increased 2.6 percent. This is a solid performance. Importantly, it's above the trend growth rate, which I peg at about 1¾ percent.

I'm often asked what the trend growth rate is and how it differs from GDP growth. The trend growth rate is the rate of growth that can be sustained by the economy over the long term. It has two main drivers: labor force growth and productivity growth. With more people working, making things and using their income to buy things, the more we can produce. Equally, if innovations in technology mean that companies can make more state-of-the-art microprocessors in an hour than they could before, that will also contribute to higher sustainable growth.

An important development of the past decade is that the trend growth rate today appears to be considerably slower than the growth trends we've previously seen in our lifetimes. This slower pace of growth is a reflection of a sharp decline in labor force growth and relatively slow productivity growth (Fernald 2016).

What's behind the decline in labor force growth? Two main things: First, the baby boomers are retiring in droves, and second, the fertility rate in the United States has declined to a low level (Hamilton et al 2017).

And despite the rampant innovations we're seeing around us, especially in the Bay Area—robots delivering take-out, driverless cars, and Alexa in every living room—these aren't yet translating into rapid gains in productivity growth. To give some context, in the 1990s and early 2000s, annual productivity gains in the United States averaged 2 to 3 percent. By contrast, productivity gains over the past decade have averaged only about 1 percent per year.

Looking ahead, I expect growth to average around 2.5 percent over this year and next. Strong financial conditions, better-than-expected global growth, and fiscal stimulus of lower taxes and higher spending have all created tailwinds that account for growth running above trend.

Growth above trend doesn't necessarily pose a particular risk at this time. But it's one of the factors I'm assessing when I'm thinking about how to best support economic growth over the medium term. In that regard, a question I'm frequently hearing as the expansion closes in on nine years is: are we "due" for a recession?

The short answer is no. Recessions don't happen because a timer goes off. Research shows that the odds of going into a recession are the same whether you're in the seventh, eighth, or ninth year of the expansion (Rudebusch 2016). Instead, recessions generally happen because of some big event: the housing crash of a decade ago or the bursting of the dot-com bubble in the early 2000s. These kinds of events are notoriously hard to predict, and the recessions that often follow don't happen because the business cycle has a time limit on it.

Given that the current pace of growth is above trend, my view is that we need to continue on the path of raising interest rates. This will keep things on an even footing and reduce the risk of us getting to a point where the economy *could* overheat, and create problems that could end badly.

Obviously, growth figures are the ones that many people are 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 maximum employment goal, we have made enormous strides and I see the labor market continuing to improve. We added about 2.2 million jobs in 2017. That's about twice the number needed to keep pace with normal labor force growth (Bidder, Mahedy, and Valletta 2016). Based on the data we've seen recently, we are set to add even more jobs to the economy this year.

With jobs growth being so robust, the unemployment rate has moved down to around 4 percent. Based on my forecast for the economy, I expect the unemployment rate to continue to edge down to 3-1/2 percent by next year. That would be the lowest rate of unemployment recorded in the United States since 1969. What's happening in the nation as a whole is also happening here in California, where the unemployment rate is already the lowest since 1969.

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. And 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 competition for workers gathers steam.

Inflation

Wage growth is the perfect segue to discuss inflation. Six years ago, the FOMC set itself the goal of 2 percent inflation. Admittedly, since then, inflation has been running below that mark most of the time. This underrun of our target reflects a number of influences. These include the weak economy following the recession, a strong dollar that reduced the costs of imported goods and services, and some special factors that had a temporary effect on prices in certain categories.

Inflation undershooting its target by a few tenths of a percentage point probably doesn't sound that concerning to most people. In fact, historically, high and rising inflation has acted as an alarm bell to warn that the economy is on an unsustainable footing. But inflation that's too low also poses a risk. Very low inflation raises the possibility of deflation – that is, falling prices – which carries with it its own set of problems for the economy. That's why, as a policymaker, I'm keeping such a close eye on the behavior of inflation, even when the economy is performing so well.

The good news is for most of the past year, inflation *has* been running closer to 2 percent. With the economy strong, and strengthening further, I expect that we'll see inflation reach and actually slightly exceed our longer-run 2 percent goal for the next few years.

Monetary Policy

I began by describing a very positive economic outlook of strong growth, low and falling unemployment, and inflation that is closing in on our 2 percent long-run goal. Against this background, the FOMC raised the target range for the federal funds rate by ¼ percentage point at our most recent meeting (Board of Governors 2018a).

We also indicated that we expect further gradual interest rate increases to be appropriate. In particular, our recent projections indicate that the center of the distribution of FOMC projections foresees a total of three to four rate increases this year and further gradual rate increases over the next two years, bringing the target federal funds rate to around 3-1/2 percent by the end of 2020 (Board of Governors 2018b). In my view, this is the right direction for monetary policy.

We are certainly not "due" for a recession, but it's equally important we keep growth on a sustainable footing to keep the strong economy going as long as possible. This gradual process of removing the monetary stimulus put in during the recession is designed to keep the healthy expansion on track, maintain inflation near our 2 percent goal, and to minimize the risk that the economy could overheat down the road.

Note that the rate increases we have put in place so far have not stalled the economy. In fact, the economy continues to steam ahead. For that reason, I am confident that we can carry on the process of gradually moving interest rates up over the next two years while seeing solid growth and historically low rates of unemployment.

That's our plan. Of course, even the best-laid plans can go awry when the unexpected happens. Therefore, my approach is to always follow the data very carefully and adjust my recommendations accordingly. If actual growth is paltry, or if there are signs of an economy that's overheating and inflationary pressures are building too fast, then I'll reevaluate my position and advocate for adjusting the path of rates accordingly.

To sum up: the outlook is very positive. The economy is on course to be as strong as we have seen in many decades and inflation is moving closer to our target. The challenge for monetary policy is to keep it that way. This is never an easy task, but we are well positioned to achieve our goals, and to respond to any unexpected twists and turns that may lie in the economic road ahead.

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