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Navigating toward Normal: The Future for Policy

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The Federal Reserve is on track to end asset purchases in the near future and has laid the groundwork for its plan to eventually normalize monetary policy by raising short-term interest rates. The process of policy normalization is unlikely to start soon, however, and its exact timing will depend on further improvements in unemployment, wages, and inflation. The following is adapted from a presentation by the president and CEO of the Federal Reserve Bank of San Francisco to business and community leaders in Las Vegas, Nevada, on October 9, 2014.

It's great to be here with business and community leaders from around Las Vegas. We had an informative tour of some redevelopment sites in downtown Las Vegas yesterday, including neighborhoods that are part of the Downtown Achieves initiative. That project has brought public- and private-sector partners together to address academic attainment in underperforming schools. My own staff at the San Francisco Fed works closely with them on this important work.

I'd like to talk to you today about the outlook for the economy, as well as address some of the whens, whys, and hows of monetary policy going forward.

Economic outlook

I'll be honest: These speeches get more and more enjoyable as time goes by because the economic outlook keeps getting better and better. Instead of gloom and doom with a scattering of hopeful notes, things are now pretty upbeat, with only a couple of standard economist's caveats thrown in.

To wit: After a dip in the first quarter, real GDP bounced back sharply in the second quarter. All the data point toward momentum having been sustained entering the second half of the year, with solid gains in consumer and business spending. Taking all the pieces of information together, I expect real GDP to grow at about a 3% annual rate over the second half of this year and next (Liu 2014).

The labor market is also looking a lot better. Over the past 12 months, we've added more than 2.6 million jobs and that momentum has been sustained. These job increases helped push down the unemployment rate from 7.2% in September 2013 to 5.9% this September.

The decline in the unemployment rate is important, because it's generally seen as the best single barometer of labor market health. But it's not the only indicator, and we're seeing continued improvement across others as well. For example, measures of job vacancies and hiring have strengthened. And a broader measure of underemployment—which includes the unemployed, people who are working part-time but want to be full-time, and people who want a job but haven't looked for one in the past four

weeks—has dropped significantly over the past year. Similarly, the number of people out of work for over six months has come way down.

While this is all good news and points to further sustained improvement, there remains considerable slack in the labor market. Because unemployment can never be zero—in any well-functioning economy, people will move in and out of jobs and new people will enter the workforce—economists look to the “natural rate” of unemployment as a measure of full employment. I put the natural rate at 5.2%, so with unemployment at 5.9%—a huge decrease from the recession’s painful 10% high—we’re still a way off from full employment. Looking ahead, with solid economic growth and job gains, I expect the unemployment rate to gradually come down, reaching 5.2% by late next year.

Another indication that the labor market still has a way to go is that we’re not yet seeing solid growth in wages (see Aaronson and Jordan 2014). At the moment, wage growth is hovering around 2 to 2¼%, when it really should be between 3 and 3½%. That’s the rate I’d expect in a fully functioning economy with a 2% inflation rate.

Why hasn’t wage growth picked up more as the economy’s improved? A recent study by Daly and Hobijn (2014) at the San Francisco Fed found that there was something of a floor on wages during the recession and recovery. Employers are generally reluctant to cut wages outright, so as the recovery has unfolded, wages have in many cases stayed stagnant, making up for the losses they didn’t—or couldn’t—incur during the depths of the recession. That is certainly a contributing factor. But, as unemployment continues its move down, we should see those effects wane and wages gradually move up.

I’m sure some employers aren’t thrilled with the idea of wages taking off. But that jump from 2 to 3% wage growth is what’s been missing in this recovery; in fact, it’s what we’ve been waiting for. More wage growth means more money in people’s pockets, which means more spending and more economic activity.

That’s important because inflation is too low. For anyone who lived through the 1970s and early ’80s, it may sound strange to say we want higher inflation. Nonetheless, persistently low, rather than high, inflation has been our concern for the past few years. Inflation has been running at 1½% over the past year. That’s well below the Fed’s longer-term inflation goal of 2%. With the economy continuing to strengthen and labor market slack dissipating, I expect we’ll see a gradual rise in inflation, reaching our 2% goal over the next couple of years.

Tapering and continued accommodative policy

The ongoing improvement in the labor market has been a primary motivation for tapering the Fed’s asset purchase program—that is, quantitative easing or QE. As you no doubt know, we’re on track to end these purchases soon, barring any dramatic changes in the economy (Board of Governors 2014b). And as the economic situation and outlook continue to get better, we’re moving closer to the time we can start thinking about normalizing policy, by which I mean raising the federal funds rate.

I want to be clear that monetary policy will remain accommodative for some time, because we’re still quite a way from our goals. We are still experiencing a good amount of slack in the labor market. We need progress on unemployment, progress on wage growth, and progress on inflation. Given the current distance from our goals and my expectation that further progress toward those goals will be gradual, it’s too early to start down the path of full normalization.

I've said it often enough that I should probably have a T-shirt, but let me reiterate: The decision to raise rates will be data-driven, not date-driven. Based on my current forecast for economic growth, employment, and inflation, it would be appropriate to start raising the fed funds rate sometime in the middle of 2015. If the economy or inflation heat up faster than I expect, we should lift rates sooner. If progress on these fronts slows, we should wait longer.

Why not now?

I've stated my case for waiting for further progress on our goals before we start raising rates. But I increasingly hear voices saying: The economy is really heating up in some places; isn't it time to start cooling things down? From my perspective, there are compelling reasons to remain on the current accommodative path of monetary policy.

For one, we still haven't reached our goals and we need strong stimulus to keep the economic expansion on track and make further progress toward full employment and 2% inflation. Accommodative monetary policy has been an important part of getting us as far along in the recovery as we are today, and we don't want to remove that support prematurely (see Swanson and Williams 2014 and Williams 2014). We have reached a point where we no longer require additional stimulus, and for that reason we're ending asset purchases. But if we were to withdraw accommodation too soon, progress toward our goals could slow or even stall.

This is actually exemplified by looking around this room—our audience is made up primarily of representatives from Las Vegas, Los Angeles, and San Francisco. They're all relatively close, geographically. But if you turn to the person next to you, or walk over to another table, there are going to be very different discussions about housing or unemployment.

One of the advantages to the Fed's system of regional representation is that economies—and economic concerns—vary from area to area. The U.S. economy is a composite of a vast and diverse country. Home prices may be increasing strongly in Texas but still struggling to recover in Connecticut. Unemployment may be extremely low in North Dakota but high in North Carolina.

Even within Federal Reserve Districts, there are dramatic variations. When I go to work on Market Street in San Francisco, I'm surrounded by cranes. The Bay Area's property market is booming—the only thing holding back growth is traffic. But in California's Central Valley, or here in Las Vegas, it's a different story. Looking at housing prices across the District, you can see how uneven the recovery has been. Home prices in Hawaii and Utah are now down less than 10% from their respective pre-recession peaks. Arizona, on the other hand, is nearly 30% behind and Nevada is trailing its previous highs by almost 40%. It's the same story across the country. Some areas were just hit harder than others by the crisis and recession (see Williams 2012 and Mian and Sufi 2013). Even if they were rebounding at comparable rates—which not all of them are—they have deeper holes to climb out of.

You can't just look at the housing market in San Francisco or unemployment in Seattle to gauge the health of the U.S. economy. You also need to look at the housing market in Las Vegas and unemployment in Yuma. I don't want to see accommodation lifted until we're on economic terra firma across the country. That doesn't mean that every municipality in America needs to be at pre-recession numbers; but it does mean we need to see further improvement in the many areas where the economy is still struggling.

The bottom line is that, in some places, the recession is fading into memory; in others, the wounds are still raw. Taking into account this diversity in experience, overall, the economy's getting better all the time, as the song goes. But we still have a way to go to get to full health.

A second issue to consider is inflation, which, as I already noted, has been too low. Considering that, it might seem strange that there's been a lot of talk about inflationary pressures lately, fears that it's going to shoot up unexpectedly. In fact, that's one of the arguments employed by some commentators who advocate an earlier interest rate hike.

In their view, the Fed is lumbering along like a dinosaur, perhaps aware of the danger, but too slow and unwieldy to react to a swift economic predator. Or they're worried we're asleep at the wheel—or too blinded by our own biases—and don't see the imminent threat.

These concerns got a lot more attention this year when inflation started to edge up. But, like Lucy with the football, just when it looked like inflation pressure might be emerging, it was snatched away. Which leads to a crucial point: To adequately judge inflation's trajectory we need to carefully analyze the data and separate the signal from the noise. Monthly or quarterly numbers, when taken in isolation, can give a false impression of new trends when in fact they are just blips in the data.

For most of 2013 and the beginning of 2014, we saw inflation that was very low, bottoming out at around 1%. There were many influences at work, including declining import prices and reductions in Medicare payments (Clemens, Gottlieb, and Shapiro 2014). So there were special factors helping to depress inflation. With those pressures ebbing, the inflation rate has floated back up. Indeed, if anything, the 1% inflation rate in 2013 was the anomaly, not the subsequent rebound to 1½%.

As for those who believe we're too myopic, or too reliant on data that confirm our own prejudices: This is a misconception. For one, the views within the Federal Open Market Committee (FOMC) fall at points all along the spectrum. For another, we are unapologetic data wonks: My decisions are formed by looking at various indicators of wage pressures, employment and growth metrics, and a multitude of price measures. I study commentary and analysis from all corners.

And while I think the Bureau of Labor Statistics and Bureau of Economic Analysis do fantastic jobs of collecting and distilling inflation data, I also look at—and point critics to—more straightforward assessments like the Billion Prices Project (2014) from the Massachusetts Institute of Technology. This tool scrapes the Internet for prices, giving a daily reading of, well, billions of prices of myriad products. It lacks the complicated adjustments and methods that characterize the government agencies' models. Nonetheless, it does track pretty closely with the official numbers. What's more, it gives an independent assessment of consumer prices that is helpful for those who may distrust official federal data. While the BPP's numbers run a tad higher on average than the official indices, it shows that price inflation remains low and shows no sign of taking off.

The signal from all these indicators, both government and independent, point to the same conclusion: Inflation trends are quite modest. As I said, I expect that we will be moving back toward our 2% longer-run goal over the next few years.

Normalizing policy

As the economy gets better, we're moving closer to setting the stage for raising interest rates. As I said, I don't think it's going to happen soon, nor do I see it being far off in the future—likely around the middle of next year is a reasonable guess to my mind. As I also said, the data will drive the decision—not just how close we are to our goals, but how quickly they come into sight. And, assuming the economy progresses as anticipated, rates will likely increase relatively gradually. This has been a fragile recovery with significant ups and downs, and there are still some lingering headwinds.

Whenever it happens—that is, whenever the data indicate is the right time—we'll raise rates as we always do during an expansion.

One of the things I hope to see when it eventually occurs is a shift in the way the public views Fed decision making. During the extraordinary economic times of the crisis, recession, and recovery, we turned to forward guidance—that is, laying out in very explicit terms where we thought the economy and policy were headed. But once we make the return to a more normal policy environment, we won't need to be so explicit. We want instead to let the public start intuiting our actions by looking at the economy and the outlook, understanding it's the data that drive decisions. We want them to understand our strategy, rather than waiting to be told what we plan to do.

The course of action we'll eventually take was charted by a lot of research and thinking about the best way to accomplish our goals with as little disruption as possible. At our last FOMC meeting, we published a high-level description of our plan to return to normal, imaginatively called "Policy Normalization Principles and Plans" (Board of Governors 2014a).

As you may know, our various quantitative easing programs have significantly expanded the Fed's balance sheet to about \$4.5 trillion. This has caused some concerns about how we will steer the economy with such a large balance sheet: one, that it might make controlling interest rates too difficult, and two, that reducing the balance sheet over time could prove disruptive. We're well aware of these issues, we've spent a lot of time thinking about them—hence, the carefully considered plan released far in advance of the actual action—and we have the tools to deal with them.

First, we'll pay interest on reserves held at the Fed. That is, when banks park their money with the Fed, we pay them interest on that money. By increasing the rate we pay to banks for the money they hold with us, we give them the incentive to keep their reserves with us, rather than having funds flow into the market and overheat the economy.

Second, we have a new tool, the reverse repo facility, which folds nonbank financial institutions into that process as well. They'll have the ability to keep their cash with us in exchange for temporarily holding our assets, with a return that's below that on excess bank reserves.

These and other tools will help us keep good control as we raise the target range for the federal funds rate. And, like all tools, we'll use them appropriately. The reverse repos in particular will be carefully managed, and we'll eventually eliminate their use when they are no longer needed.

As for reducing the balance sheet over time, we won't be doing it all at once. At some point after we raise the target range for the federal funds rate, we will stop reinvesting maturing securities and principal

payments from our asset holdings. Thereafter, as our securities mature, they'll simply roll off, and our balance sheet will slowly shrink to a more normal size.

Instead of going further into more extensive technical explanations, I'll note that this is how policy is best managed: having a well-thought-through plan. Once you have the plan, it's just a matter of executing it. I have every faith that we've looked at this from every angle and that we can manage the transition over time.

Conclusion

So the message is that things are getting better. We're on track to end our asset purchases and we're preparing for the time the economy can sustain an end to accommodation. We'll want to see improvements in unemployment, wages, and inflation, and we'll be driven by the data. But all in all, it's good news—with just a few of those requisite caveats thrown in.

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