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By John C. Williams, President and CEO Federal Reserve Bank of San Francisco
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The View from Here:
The Economic Outlook and Its Implications for Monetary Policy

Good evening, at least from me; good afternoon, in your case. It's truly a pleasure to be speaking to you, though I must admit it would be more of a pleasure if I could be there in person. What I'd like to do is give you the 30,000-foot view: the economic outlook of the U.S. as a whole and how I view the trajectory of monetary policy in that context.

Economists rarely make definitive statements—we usually add dozens of modifiers and caveats, which is why a typical sentence can run to about 90 words. But I feel comfortable saying in the absolute that 2015 is going to be a very interesting year for monetary policy.

Now is probably a good time to deliver the usual disclaimer that the views expressed are entirely my own, and do not necessarily reflect those of others in the Federal Reserve System.

If you're a Fed-watcher, you *know* they don't reflect the views of some of my colleagues….

The outlook

As you probably know, the Fed has a dual mandate of full employment and price stability, and our aim is to set monetary policy that best achieves both those goals.

Starting with employment, the U.S. Congress mandated a goal of "maximum employment"…though it didn't actually define precisely what that meant. Which is a good thing—it means we have to think hard about what the right employment level should be in a healthy economy, examine the data, and use economic analysis based on a number of factors, rather than aiming for an arbitrary or potentially anachronistic target. Most economists—including me—think about maximum employment in terms of the unemployment rate. When the economy is at full strength, the unemployment rate is somewhere between 5 and 5½ percent. My view, to be precise, is that 5.2 percent is the right number.

We're obviously getting much closer to our target of full employment. The current unemployment rate of 5.5 percent is not only a positive sign in and of itself, it's a measure of our progress: It's dramatically lower than the 10 percent peak we saw at the height of the Great Recession. In addition to the falling unemployment rate, we're seeing exceptional job growth and improvement across multiple labor market indicators. They all tell the same story: That the U.S. economy and labor market are on the mend and closing in on the full employment goal. My view is that we will reach maximum employment by the end of this year, if not sooner. Indeed,

given the momentum in the economy, there's a good chance we could see the unemployment rate fall below 5 percent sometime later this year or next year.

I've been in this job for four years now, which have not exactly covered the cheeriest of economic times. In the early days, it was hard not to feel like a harbinger of doom when I spoke to groups like this. So it's a very, very welcome day that I can say that we're closing in on our maximum employment goal.

Turning to our second mandate, price stability, we again use a range of economic analyses to determine our goal because Congress—again in its infinite wisdom—didn't specify what, exactly, "price stability" should mean. We, meaning the Federal Open Market Committee or FOMC, define it as a 2 percent inflation rate over the medium term. Not every month, not every year, but *on average* we want 2 percent inflation, based on the most comprehensive measure of prices of consumer spending. Currently, that number is well below our 2 percent goal. In fact, it's been below 2 percent for the past few years.

In that context, how do I see the future of our price stability mandate unfolding? Despite the current low rate of inflation, I'm actually quite confident that we'll be able to reach our 2 percent target within the next few years. This—as my inbox makes clear—provokes the question of why I expect that inflation will pick up, considering that it's been persistently low for so long.

My answer is that, with the U.S. economy improving and unemployment falling to quite low levels, I expect wage pressures to build and price pressures to return to more normal levels over the course of the next two years. There are also significant near-term factors currently pushing inflation down that I expect to be transitory: falling import and energy prices due to global economic developments and the decline in oil prices.

Taking those in turn: First, wage and price pressures. One of the reasons people question inflation's momentum is that wage growth has been extremely sluggish. In a normal cycle, when the economy picks up, wage growth follows—and that hasn't happened yet. But there are reasons for that.

My research staff has been studying a feature of the last recession with the charming title "downward nominal wage rigidity." In essence, employers were loath to cut wages during and after the Great Recession. As a result, wages have remained stagnant to make up for the pay cuts that never came, but businesses wanted to impose.[1] As the economy picks up, these pent-up wage cuts will dissipate, the gap will close, and we should see wages start to rise more strongly.

This reflects the broader tendency for a lag between the "cause" of the economy rebounding and the "effect" of wage inflation.[2] If past is prologue, as Shakespeare wrote, we should look to prior recessions, which have followed the same pattern: one in which wage growth doesn't really start to pick up until the economy nears full employment. As I said earlier,

[1] Daly and Hobijn (2015).
[2] Daly and Hobijn (2014).

that's in sight, and I expect wages to start moving up as we get closer; but given historical precedent and economic patterns, I'm not surprised that we haven't seen that movement yet. As the unemployment rate goes from the mid-5s down to the low 5s over the rest of the year, we're going to see a labor market that's much stronger, which will spur wage and price growth, which, in turn, will overwhelm some of the other factors that have been pushing inflation down—which I'll turn to now.

The first is falling import prices. Europe, China, and Japan, the biggest economies outside the United States, are all experiencing disappointment in growth and inflation. With the exception of the U.S. and a handful of other countries, the global economic outlook has darkened. That has led to strong policy actions, both by central banks and governments abroad, to stimulate their economies.

So what happens when you have weakness abroad and those central banks are trying to stimulate their economies? One effect is that it causes their currencies to fall in value relative to the dollar. This is a standard function of monetary policy, and I should point out that the strength of the dollar relative to other currencies reflects the weaker economic conditions in those countries compared to the U.S.

The end result is that the U.S. dollar has increased in value over the past year, which has lowered the prices we pay for imported goods and services, which in turn has pushed down the U.S. inflation rate.

The second is energy—I don't have to tell anyone here that oil prices have plummeted. And that's having an enormous impact because energy is a significant part of the consumer spending basket. So as gasoline and other energy prices have come down sharply, they've also lowered the inflation rate.

What do I think of these two factors? It's something of a personal tenet that policymakers have to be very careful about not reacting to short-term fluctuations in commodity or other import prices. Instead, I take a perspective that looks one or two years ahead—research shows that's the minimum amount of time it takes for monetary policy to have its full effect.[3] What I'm considering, as a policymaker, is what effect those factors that are currently unfolding—movements in the U.S. economy, weakness abroad, oil prices—will have not this week or this month, but later this year and in 2016 and 2017. Given that lag between the implementation of policy and its full effect, the question should be: What's the path we're on and what's the right monetary policy for that path?

History and experience show that energy price swings leave an imprint on inflation in the short term, but don't affect underlying inflation rates over the medium term.[4] The same holds true for movements in the exchange value of the dollar: They obviously affect inflation in the short run, but they don't have much of an impact further down the road.[5]

[3] Havranek and Rusnak (2013).
[4] Evans and Fisher (2011) and Liu and Weidner (2011).
[5] Gust, Leduc, and Vigfusson (2010).

I'm therefore looking at underlying rates of inflation, not just the month-to-month movements, but the fundamental trends. Fed economists are frequently accused of neither eating nor driving, because we like to look at core inflation, which excludes food and energy prices. For the average consumer, those matter a lot—you can't really talk about what a dollar can buy if you don't look at those products. But for economic trends, and for guiding monetary policy, measures of inflation that remove the most volatile components, like core inflation, or something called the "trimmed mean" inflation,[6] give a better lay of the land.

What I see when I look at the data that strip out the short-term volatility is an economy that's got a good head of steam and is getting close to full employment and an inflation trend that's running about 1½ percent based on the trimmed-mean measure. That's why, as things continue to get better, I see the strengthening domestic economy overwhelming the energy and currency valuation impacts, and inflation gradually moving back to 2 percent.

Inflation expectations from business and consumer surveys are generally consistent with that forecast. On the other hand, financial markets are sending mixed signals, with declining yields on inflation-indexed securities suggesting that inflation expectations may have fallen. It's always important to listen to what financial markets are saying. But it's also important to note that the research shows the meaning of these movements is not definitive.[7] And while markets are important, interpreting their fluctuations is not a substitute for the economic research and

[6] See http://www.dallasfed.org/research/pce/index.cfm.
[7] Christensen, Lopez, and Rudebusch (2010) and D'Amico, Kim, and Wei (2014).

analysis we look to when thinking about economic developments and determining appropriate policy.

In a nutshell: Things are looking better—in fact, they're looking downright good. The economy is showing solid momentum and there's good news in virtually every sector. I expect U.S. growth to be about 2½ percent in real GDP. I see the continued improvements in the economy pushing wages and prices up, and inflation moving back toward its target. And, as I said, I expect to reach full employment by the end of the year.

Implications for monetary policy

Of course, what everyone wants to know is what all this means for monetary policy.

I personally still think it's appropriate to start the process of normalizing monetary policy this year. "Normalizing policy," as we all know, is code for "raising interest rates." The exact timing for that is going to depend on the data—I cannot emphasize enough, by the way, that our decisions are data-driven. I say it in every speech, every interview, every conversation…. The data may push us a little further in one direction or another, and there will be a lot of discussion and debate. But assuming that things unfold along the lines I've forecast, I think that by mid-year it will be the time to have a discussion about starting to raise rates. I'm not making a prediction about what the Fed will do; I am saying that in my view, it would be appropriate to start weighing the pros and cons of taking action at that time. This is a good thing: After all, the economy's improved a lot, unemployment's coming down, and we may be able to start cutting

back on accommodation because of that strength. Of course, the one thing that would change my view would be if the data contradicted the forecast I laid out today.

Not everyone agrees, of course. There are a number of people who think we should wait until inflation is very close to, or has crossed, the finish line. They're mainly worried that raising rates too soon would allow inflation to fall further and possibly derail the recovery. The argument is: What's the rush? Why not get as much evidence as possible that your forecast is right?

The case for extensive patience certainly has valid points, and esteemed supporters, so let me explain my position.

First, it's important to remember that I'm not talking about instituting tight policy, I'm talking about taking a first step in pulling back somewhat on what is a very high degree of accommodation. To use an over-worn, but accurate, analogy: There's a difference between easing off the gas and applying the brakes. Monetary policy has been extremely stimulative for the past six-plus years, and it's going to remain so for quite some time. Even after we start raising interest rates they will be very low and the Fed's $4 trillion-plus balance sheet will continue to provide substantial stimulus. So no one should worry that we're pulling the rug out from underneath the economy.

Second is the factor I mentioned previously: Monetary policy, as Milton Friedman famously reminded us, has long and variable lags.[8] As I said, it usually takes a year or two for policy to have its full effect. As a result, policy must be forward-looking. When you're driving towards a stoplight, you don't keep your foot on the accelerator; you ease off so you're ready to stop at your target. Otherwise you slam on the brakes—and probably wind up in the middle of the intersection.

The data convince me that inflation will move back up to our target as the economy strengthens and we close in on full employment. Nearing our goal means easing up on the gas. By waiting until we're face-to-face with 2 percent inflation, we could drastically overshoot the mark—winding up in that metaphorical intersection or even fully running the red light. Overshooting our target would force us into a much more dramatic rate hike to reverse course, which could have a destabilizing effect on the markets and possibly damage the economic recovery. The decision to raise rates is actually three decisions: Not just when, but how quickly and how high. I see a safer course in a gradual increase, and that calls for starting a bit earlier.

It's been posited by some that the risk of overshooting the inflation target is minimal, because inflation is so low and is unlikely to accelerate quickly. I'll offer a counterpoint to that, from a time in U.S. history when things looked similar to the snapshot today: In 1965, when the Fed was debating whether to tighten policy, core inflation was 1¼ percent, labor costs were

[8] Friedman (1961).

growing relatively slowly, and the unemployment rate was about one-half percentage point above the estimate of maximum employment at that time.

Only 18 months later, core inflation was over 3 percent, labor cost growth had more than quadrupled, and the unemployment rate was down three-quarters of a percentage point—the economy was on a tear. I'm not predicting that this will happen today, but it's a reminder of just how fast things can change when the economy is strong.[9]

The Fed has a lot of decisions ahead, and people have a lot of opinions about those decisions. I'm sure I'm going to hear some of them in Q&A.... But the attention shouldn't just be focused on what the Fed's going to do, because, as you well know, there's also the story that's unfolding globally: the policy decisions in Japan, Europe, and elsewhere will spill over to other economies around the world.

Now I've talked a lot about my forecast and what I expect to happen. Of course, events rarely follow the script. There are downside risks to the forecast—mostly related to developments abroad. And there are upsides as well, for example, we could have another year of better-than-expected job growth.

Typical economist, always with a caveat.

But also typical of an economist, I'll be watching the data and the decisions that are being made, and not just relying on a forecast.

[9] See Orphanides and Williams (2013) for a discussion of monetary policy during this episode.

And that's really the message here, my mantra: Decisions are data-driven.

The data convince me that we'll close in on maximum employment by the end of the year. The data convince me that as we do, wage and price pressures will rise. The data convince me that as that happens, it will push inflation up, and we'll meet our target in about two years. The data convince me that lags in monetary policy mean acting before we reach our goals, not when we reach them, to avoid overshooting the targets. And that means the data convince me that the time is coming when we'll be making our first steps down the road to normalization.

Thank you.

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