A Balanced Approach to Monetary Policy

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The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

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Background

The target federal funds rate stands in a range of 100 to 125 basis points. The Federal Open Market Committee (FOMC) raised the federal funds rate in March as well as June of this year. I voted for both of these increases. I also supported the FOMC's decision in September to begin the process of gradually reducing the size of the Federal Reserve balance sheet. I believe that the gradual and phased-in design of this plan should allow the Fed to reduce the size of its Treasury and mortgage-backed securities portfolios without materially impacting either of these important markets.

Balancing Full Employment and Price Stability

As of November 2017, several key labor market indicators suggest that the U.S. economy is at or near full employment. The headline unemployment rate and other measures of labor market utilization are now at or below pre-recession lows. In addition, Dallas Fed economists expect the U.S. economy to continue to grow at rates which should cause labor market conditions to tighten further. While real wage growth has been sluggish, we are beginning to see welcome signs of increasing wage pressures which are consistent with removal of remaining slack from the labor market.

Inflation has remained below the Federal Reserve's 2 percent target. Moreover, the 12-month Dallas Fed Trimmed Mean PCE, a measure of core inflation (which Dallas Fed economists believe provides a better indicator of underlying inflationary trends than headline readings), started the year at 1.9 percent and has drifted down to 1.6 percent in the latest reading. While some of this recent decline is likely transitory, my view is that some of the more persistent weakness is due to structural forces, which are limiting the pricing power of businesses and are likely having a muting effect on wage pressures for certain types of workers. These structural forces include technology-enabled disruption and, to a lesser extent, globalization (see Appendix A, Technology-Enabled Disruption and Its Implications).

How should the FOMC address the current situation in which one aspect of our mandate is being met while another objective is not yet being met? In this essay, I intend to address this question.

The Fed's Mandate

To help the public understand its framework for monetary policy, the FOMC released in January 2012, and reaffirmed in January 2017, its "Statement on Longer-Run Goals and Monetary Policy Strategy."[1] This document articulates the FOMC's commitment to fulfilling its statutory mandate

from Congress of promoting maximum employment, stable prices and moderate long-term interest rates.

In public discussions, Fed officials typically express this framework as a "dual mandate"—full employment and price stability. The Fed uses a variety of economic and labor market indicators to judge whether the full employment objective is being met. To judge whether the price stability objective is being met, the FOMC has articulated a "symmetric" inflation goal of 2 percent, as measured by the annual change in the price index for personal consumption expenditures (PCE). The term "symmetric" means that the FOMC would be equally concerned if inflation ran either persistently above or persistently below this 2 percent objective.

These dual-mandate longer-term goals are generally complementary. However, in those cases where they are not, the FOMC has said that it will seek to follow a "balanced approach" in promoting these goals, taking into account the magnitude of the deviations and the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate.

The Current Situation

As we sit here today, the headline unemployment rate stands at approximately 4.1 percent. In addition, our Dallas Fed economists also look at the U-6 rate, a broader measure that includes the percent of unemployed, plus the number of discouraged workers, plus people working part time who want to work full time. This measure of labor market utilization now stands at approximately 7.9 percent, matching its prerecession low.

In addition, we also look closely at the labor force participation rate (the number of employed plus unemployed looking for a job as a percentage of the population 16 and older), which now stands at 62.7 percent. This compares with a participation rate of 66 percent in 2007. Our economists believe that a majority of the decline in participation is due to the aging of the population and, as such, we believe that current participation levels are consistent with an economy that is at or near full employment. Looking ahead, Dallas Fed economists expect this aging trend to continue in the U.S., as well as across almost all advanced economies.

Over the next 10 years, we expect that, due to aging of the workforce, the U.S. participation rate will decline further to 61 percent.[2] This aging trend will likely reduce the rate of labor force growth in the United States. Because GDP growth is comprised of growth in the workforce plus gains in labor productivity, weaker expected workforce growth is likely to negatively affect potential GDP growth in the years ahead—unless steps are taken to mitigate these effects.

The question arises as to the actual level of maximum sustainable employment, which can be defined as the maximum level of employment that does not generate undue price pressures. Because inflation pressures typically manifest themselves with a lag, this is a judgment that is much easier to make in hindsight than in real time. Having said this, Dallas Fed economists

currently believe that we are either at or near the level of maximum sustainable employment, and may well move materially beyond maximum sustainable employment sometime in 2018.

Regarding inflation, we have been notably running behind our 2 percent target for the past several years. My own view has been that, while cyclical inflationary pressures are building, which should become more apparent over time, these pressures are being at least partially offset by the structural headwinds of technology-enabled disruption (see Appendix A) and, to a lesser extent, globalization. Our Dallas Fed economists believe that, as labor market conditions continue to tighten, cyclical inflationary forces should ultimately offset these structural headwinds such that we will likely achieve our 2 percent target in the medium term. We are of course mindful that progress in reaching our inflation mandate may well be slower and more uneven than many analysts currently anticipate.

In summary, as a policymaker, I am balancing a labor market that is likely to become increasingly overheated in the months ahead with a level of inflation that is running somewhat below our 2 percent goal. While I believe cyclical inflationary forces are building, there is some question regarding how long it will take to reach our price stability objective.

Monitoring for Evidence of Building Imbalances

As a central banker, I want to be vigilant to imbalances and distortions that can build as a result of accommodative monetary policy. I have argued that monetary policy accommodation is not "free"—there are costs to accommodation in the form of distortions and imbalances in consumer decisions as well as in investing, hiring and other business decisions. More specifically, experience suggests that the greater the overshoot of full employment, the more difficult it is to unwind imbalances when growth ultimately slows—as it certainly must.

When excesses ultimately need to be unwound, this can result in a sudden downward shift in demand for investment and consumer related durable goods. There are surprisingly few historical examples of "soft landings" in cases where employment has risen above its maximum sustainable level.

It is of course possible that "this time will be different," but as I assess the condition of the U.S. economy, I am carefully monitoring evidence that might suggest growing risks of real imbalances, which could threaten the sustainability of the current economic expansion. For example, the headline unemployment rate has fallen by 70 basis points over the past year, nearly matching the average rate of decline over the prior seven years of the expansion. If this rate of decline continues, this will further tighten labor market conditions and would likely add to excesses and imbalances accumulating in the economy.

Excesses can also manifest themselves in financial imbalances. While I would prefer to rely primarily on macroprudential policy tools to manage financial imbalances, I am nevertheless monitoring various measures of potential financial excess. I monitor these and other market

measures because I am aware that, as excesses build, we are more vulnerable to reversals which have the potential to cause a rapid tightening in financial conditions, which in turn, can lead to a slowing in economic activity. Examples of potential excesses might include:

- The U.S. stock market capitalization now stands at approximately 135 percent of GDP, the highest since 1999/2000.[3] Correspondingly, commercial real estate cap rates and valuation measures of debt and other markets appear notably extended.

- Measures of stock market volatility are historically low.[4] We have now gone 12 months without a 3 percent correction in the U.S. market.[5] This is extraordinarily unusual.

- While household debt to GDP has improved over the past eight years, corporate debt is now at record highs.[6] I am not overly concerned about current levels of corporate debt because, importantly, financial sector leverage has declined substantially since the Great Recession. However, U.S. government debt now stands at approximately 75 percent of GDP,[7] and the present value of unfunded entitlements now stands at approximately $49 trillion.[8] In my view, the projected path of U.S. government debt to GDP is unlikely to be sustainable—and has been made to appear more manageable due to today's historically low interest rates.

- Debt and equity securities trading volumes have markedly declined over the past several years. For example, NYSE equity trading volume on average for 2017 is down 51 percent from 2007 levels, while the NYSE market cap has increased 28 percent over the same time period.[9] I would also note that margin debt is now at record-high levels.[10] In the event of a sell-off, high levels of margin debt can encourage additional selling, which could, in turn, lead to a more rapid tightening of financial conditions. Sufficient market trading liquidity is key to managing the resulting increased volume. I am cognizant that lower trading volumes may be due, in part, to low levels of market volatility and may also be due to regulations such as the Volcker rule.

In the context of managing potential financial imbalances, I believe that we have been well served by strong macroprudential bank regulatory policies which have created tough capital requirements and regular stress testing for large systemically important institutions. These measures have helped guard against excessive debt buildup and creation of other imbalances which often accompany elevated levels of asset valuation.

I strongly favor a prudent review of Dodd–Frank and the Volcker rule, as well as regulatory relief for small- and mid-sized banks. However, I also believe that maintaining strong macroprudential policies for big banks—particularly stringent capital requirements and rigorous annual stress testing—is very important for managing potential financial imbalances at this stage in the economic cycle.

Implications for the Stance of Monetary Policy

In assessing progress in reaching our dual mandate, I am increasingly cognizant of the risks posed by potential economic and financial imbalances. Such imbalances, if allowed to build, have the potential to, at some point, threaten the sustainability of the expansion and the attainment of our dual-mandate objectives.

The FOMC's stated strategy indicates that when objectives are in conflict—such as appears to be the case today—we are committed to following a "balanced approach" to policy. This approach involves assessing "other" factors, such as the magnitude of deviations from our longer-run inflation goal and deviations of employment from the Committee's assessment of its maximum level, as well as the timing of expected return to mandated and/or sustainable levels. Put more plainly, even though we are not meeting our inflation objective, the size of the expected full employment overshoot is growing and should be taken into account in assessing appropriate monetary policy actions.

Regarding inflation, I would reiterate that cyclical forces are building, which should increasingly offset the structural forces of technology-enabled disruption and, to a lesser extent, globalization. I am also mindful that if we wait too long to see actual evidence of inflation, we may get behind the curve and have to subsequently raise rates more rapidly. This type of rapid rate rise has the potential to increase the risk of recession.

Lastly, due to the structural headwinds of aging demographics and slowing workforce growth in the U.S. as well as most developed economies, I believe that the neutral nominal rate of interest is likely in the neighborhood of 2.5 percent—materially lower than we are historically accustomed. As such, I think it is important that, to the extent possible, monetary policy accommodation be removed in a gradual and patient manner. I would like to avoid a situation where the FOMC is playing "catch-up" in raising interest rates.

Taking all these factors into account, and from a risk management point of view, I believe it will likely be appropriate, in the near future, to take the next step in the process of removing monetary accommodation. This should be done in the context of an overall strategy of removing accommodation in a gradual and patient manner. I believe this strategy will increase the likelihood of sustaining and extending the economic expansion in the U.S.

Appendix A

Technology-Enabled Disruption and Its Implications

As I have been discussing for the past two years, technology-enabled disruption means workers increasingly being replaced by technology. It also means that existing business models are being supplanted by new models, often technology-enabled, for more efficiently selling or distributing goods and services. In addition, consumers are increasingly being able to use technology to shop for goods and services at lower prices with greater convenience—having the impact of reducing the pricing power of businesses which has, in turn, caused them to further intensify their focus on creating greater operational efficiencies. These trends appear to be accelerating.

It is likely that disruption is a factor in economic outcomes being increasingly skewed by educational attainment levels of workers. That is, for those who have a college education, the unemployment rate stands at 2.0 percent and the labor force participation rate is 73.7 percent. If you have some college, the unemployment rate is 3.7 percent and participation is 65.8 percent; a high school diploma, the unemployment rate is 4.3 percent and participation is 56.9 percent; and some high school education, the unemployment rate is 5.7 percent and participation rate is 46.1 percent.

Increasingly, workers with lower levels of educational attainment are seeing their jobs restructured or eliminated. Unless they are retrained, these workers often see their productivity and incomes decline as a result of disruption. This may help explain the muted levels of wage gains and overall labor productivity growth we see in the U.S. as well as other advanced economies.

The impact of technology-enabled disruption on the workforce is likely less susceptible to monetary policy—it requires structural reforms. The reforms could include improving early childhood literacy and overall college readiness in order to increase the percentage of students who graduate college in six years or less—now estimated at 59 percent in the U.S.[11] It would also include stepped-up efforts to increase middle-skills training in cities across the U.S. in order to improve employment, close the skills gap (not enough workers to fill skilled jobs) and raise worker productivity. These initiatives could improve educational attainment levels in order to help our citizens better thrive in a world that increasingly demands greater education, training and adaptability.

Disruption may also help explain why companies, facing one or more disruptive competitors, have been more cautious about making capacity-expansion decisions as well as investing in major capital projects. It may also help explain the record level of merger and acquisition activity globally over the last few years, as companies attempt to address disruptive changes and lack of pricing power by achieving greater scale economies in order to maintain or improve profit margins.

[1] See the statement at: www.federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf.
[2] Refers to total participation rate for those age 16 and older; estimates are as of October 2017. Source: Bureau of Labor Statistics, www.bls.gov/opub/mlr/2017/article/projections-overview-and-highlights-2016-26.htm.
[3] Wilshire 5000 Price Index (Full Capitalization)/GDP, as of Sept. 29, 2017. Sources: Dow Jones and Bureau of Economic Analysis.
[4] According to the monthly average of daily close of the CBOE Market Volatility Index New Methodology (VIX), October 2017 had the lowest levels on record.
[5] As of Nov. 16, 2017. Source: LPL Financial Research, published on Oct. 22, 2017, https://lplresearch.com/2017/10/22/here-it-comes-the-longest-streak-ever-without-a-3-correction/,
[6] Refers to nonfinancial corporate debt as a percent of GDP as of second quarter 2017. Sources: Federal Reserve Board and Bureau of Economic Analysis.
[7] U.S. Treasury and Bureau of Economic Analysis, as of third quarter 2017.
[8] "The 2017 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds," U.S. Social Security Administration, July 13, 2017; "The 2017 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds," Centers for Medicare & Medicaid Services, July 13, 2017.
[9] 2017 levels are averages from January–October 2017. 2007 levels are averages from January–December 2007. Trading volume refers to average dollar volume. Sources: NYSE; World Federation of Exchanges; Federal Reserve Bank of Dallas calculations.
[10] As of Oct. 31, 2017. Source: NYSE.
[11] "The Condition of Education 2017 (NCES 2017-144)," Undergraduate Retention and Graduation Rates, U.S. Department of Education, National Center for Education Statistics, 2017.