SPEED LIMITS AND STALL SPEEDS: FOSTERING SUSTAINABLE GROWTH IN THE UNITED STATES

Remarks by

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INTRODUCTION

It's great to be with you today. In my travels, I often find myself in a debate about which is the greatest city in the world to live in. Naturally, Sydney and San Francisco always come out at the top of the list, owing to their natural beauty nestled on the water's edge, rich cultural diversity, cosmopolitan lifestyles, and culinary excellence, not to mention sky-high real estate prices.

All that's true, but I would claim that we are kindred spirits at a much deeper level. We are steeped in a frontier spirit that bravely looks ahead toward a future of boundless possibilities. At a time when many around the world have become mired in pessimism and look longingly to the past, it's important to reignite this spirit of unbridled optimism in seeing our way through the obstacles before us.

Among our other commonalities is a mutual stake in the economic well-being of the other. Of the many exports and imports that flow between our two nations, one of my favorites is the great Australian rock band, AC/DC. One advantage of being a rock star is that you can live by the motto, *"we're just livin' for today.*"

For those of us who aren't rock stars, but are more concerned with r-star, well, we need to have an eye toward tomorrow. In the current context, that means turning our attention from getting the economy back on track to keeping it there, while guarding against the next calamity.

In the United States, we have reached a turning point; a transition from recovery to ongoing economic expansion. The main goal of U.S. monetary policy is therefore to keep the expansion going as long as possible. That entails bringing monetary policy back to a more normal setting and taking actions to keep the economy on a path that neither exceeds its speed limit, nor stalls. This is what I will discuss with you today.

And this is a good time to insert the usual Fed disclaimer that the views expressed are mine alone and do not necessarily reflect those of others in the Federal Reserve System.

THE U.S. ECONOMY HAS RECOVERED

First some context: The Federal Reserve is the central bank of the United States. It has a unique public-private structure, with some policymakers appointed by the President of the United States, and others, like myself, appointed by private boards.

As President and CEO of the Federal Reserve Bank of San Francisco, I lead one of the 12 regional Federal Reserve Banks. My District, which includes the western United States, covers about one-fifth of the U.S. population and economy. Among my responsibilities, I bring the perspectives of my region to the Federal Open Market Committee, or FOMC – the Federal Reserve's monetary policy committee.

I once had a T-shirt printed up that reminded folks that the decisions we make at the Fed are "data-driven," and they are. Although we live in a hyper-political era, the Fed is strictly apolitical … and as one of *America's* great exports, Lady Gaga, would say, we were "born this way." Our enterprise is unique within the U.S. government in both function and structure, and our design allows us to make decisions independent of short-term political influence. We base our decisions on what's best for the long-term health of the economy, rather than "living for today."

The U.S. Congress has mandated that our job is to keep the economy stable and on track, with a focus on two big goals: maximum employment and price stability. We want everyone who wants a job to be able to find one and for inflation to average 2 percent per year over the long run.

Today, the U.S. economy is about as close to these goals as we've ever been. Among other things, we've fully recovered from the recession.

When it comes to our employment goal, this is typically viewed in terms of the unemployment rate relative to the natural rate of unemployment – by this I mean the level consistent with an economy that is running neither too hot nor too cold. We can't know precisely where this magic number is, but I put it at about 4¾ percent.

Today, the U.S. unemployment rate is 4.3 percent – meaning that we've not only reached the full employment mark, we've exceeded it by a fair amount. Given the strong job growth we've been seeing in the United States, I expect the unemployment rate to edge down a bit further and remain a little above 4 percent through next year.

Meanwhile, inflation has been running somewhat below the Fed's goal of 2 percent for the past few years. In the past, this low rate of inflation was the product of a number of factors – the recession and the strength of the U.S. dollar being the two main ones. Recently, some special transitory factors have being pulling inflation down. But with some of these factors now waning and with the economy doing well, I expect we'll reach our 2 percent goal sometime next year.

RISK

Now, I'd love to be able to tell you that the news is all rosy and that our work here is done. Unfortunately, they don't call economics "the dismal science" for nothing. I'm paid to consider what potholes may be dotting the road ahead.

For starters, the very strong labor market actually carries with it the risk of the economy exceeding its safe speed limit and overheating, which could eventually undermine the sustainability of the expansion.

When you're docking a boat in Sydney Harbour, the San Francisco Bay, or elsewhere, you don't run it in fast towards shore and hope you can reverse the engine hard later on. That looks cool in a James Bond movie, but in the real world it relies on everything going perfectly and can easily run afoul. Instead, the cardinal rule of docking is: Never approach a dock any faster than you're willing to hit it. Similarly, in achieving sustainable growth, it is better to close in on the target carefully and avoid substantial overshooting.

GOLDILOCKS

What this means is that we do not want our economy to run too hot or too cold.[1] Like Goldilocks, we want our porridge to be just right.

During the recession and recovery, jump-starting and speeding the recovery required historically low interest rates. Today, interest rates in the United States remain low – and this is even true after the most recent Fed action, which I'll get to in a moment.

I'm sometimes asked why we don't just leave things as they are and not raise interest rates. After all, if things are going well, why change? The answer is that gradually raising interest rates to bring monetary policy back to normal helps us keep the economy growing at a rate that can be sustained for a longer time.

If we delay too long, the economy will eventually overheat, causing inflation or some other problem. At some point, that would put us in the position of having to quickly reverse course to slow the economy. That risks stalling the expansion and setting us back into recession.

My goal is to keep the economic expansion on a sound footing that can be sustained for as long as possible. The last thing any of us want is to undermine the hard-won gains we've made since the dark days of 2008 and 2009, when it seemed like the U.S. and world economies were on the verge of collapse.

Therefore, we're in the process of normalization. At our June meeting, the FOMC undertook the second ¼ percentage point increase in our main policy interest rate this year. And we announced that we expect that economic conditions will warrant further gradual increases in the future.[2]

Now, I know there has been some general concern that as we normalize our monetary policy in the United States, it could cause market turbulence in countries near and far.

While my own primary focus as a U.S. policymaker is on what's best for our domestic economy, I want to reassure you that we are cognizant of the fact that our domestic actions have a global impact. The last thing we want to do is fuel unnecessary or avoidable volatility or disruption – whether we're talking about domestic markets or international markets. That's one of the advantages of the gradual approach to normalization that we're taking and why we're being very clear, transparent, and open about how we're making decisions.

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[1] Williams (2017).
[2] Board of Governors (2017a).

THE BALANCE SHEET

My focus to this point has been on what we often call conventional monetary policy – that is, changes in short-term interest rates. We also made use of so-called unconventional policy actions over the past decade that will also need to be normalized.

For those who might not be as familiar with this, let me offer some background: The period since the financial crisis and Great Recession of 2007 through 2009 has been *extra*ordinary … and that's an understatement.

To save the U.S. economy from deeper recession and accelerate the economic recovery, the Fed purchased trillions of dollars of long-term Treasury and mortgage-backed securities. By reducing long-term interest rates and helping to stabilize financial markets during the crisis, the Fed helped the U.S. economy achieve the relatively healthy state that it's in today.[3]

After making these purchases, we significantly increased the size of the Fed's holdings. Right now, the Fed's balance sheet is around $4.5 trillion. We are currently keeping it at that level by reinvesting any principal payments we receive.

Now that the U.S. economy has fully recovered, the Federal Open Market Committee indicated earlier this month that it intends to gradually reduce these holdings by cutting back on the amount we reinvest every month.[4] We said we would likely start this process of normalizing the balance sheet this year, assuming the economy evolves broadly as expected.

At the outset, we'll start nice and easy, letting our holdings of Treasury securities decline by $6 billion a month, and those of mortgage-backed securities (MBS) by $4 billion per month. Thereafter, we'll increase these caps by $6 billion and $4 billion, respectively, every three months, until they reach $30 billion per month for Treasuries and $20 billion per month for MBS. From then on, we'll leave these caps in place, and our securities holdings will continue to decline in a gradual and predictable manner.[5]

We'll continue this process of letting the balance sheet gradually shrink until we get to the point that we're holding no more securities than necessary to implement monetary policy efficiently and effectively. While we haven't settled on what that exact number

[3] Williams (2014) and Engen, Laubach, and Reifschneider (2015).
[4] Board of Governors (2017a).
[5] Board of Governors (2017b).

will be, it will definitely be a lot lower than it is now. With that said, it will be higher than before the financial crisis.[6]

We also affirmed that balance sheet management is to take place in the background. Indeed, our modus operandi throughout this process will be similar to that which we've adopted for normalizing conventional monetary policy: widely telegraphed, gradual, and – yes – boring.

Of course, none of us have a crystal ball. The FOMC has made clear that it would be open to changing course if changes in the economic outlook were to warrant such a move.[7] Most importantly, we will continue to use conventional monetary policy tools – raising and/or lowering interest rates – as the primary lever we operate to keep the economy from overheating or running too cold.[8]

CONCLUSION

To summarize, it's been a long, hard road, but we in the United States have finally attained a recovery from the global financial crisis and the Great Recession.

Because no good deed goes unpunished, monetary policymakers who worked very hard to help our economy recover are now faced with the challenges of protecting what we've gained and preparing for the next storm.

Our goal, therefore, is to foster sustainable growth. This requires keeping our economy in the Goldilocks zone: not too hot, not too cold. It also necessitates bringing both conventional and unconventional monetary policy back to normal.

The more public understanding, the less chance that said actions will fuel unnecessarily volatility in the markets. Therefore, our process has been widely telegraphed and it will continue to be gradual, predictable and transparent … or in a word, "boring."

I hope I'll not be perpetuating an unfair stereotype about economists if I say that "boring" is a virtue. Indeed, my new mantra is, "Boring is the new exciting."

Thank you very much.

[6] Board of Governors (2017b).
[7] Board of Governors (2017b).
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