Too low for too long

The economy in 2014 continues to grow steadily. Last year, the economy expanded by 2.5 percent—a meaningfully faster rate than in the prior two years. That growth rate was solid enough to ensure continued steady declines in unemployment and came despite tax increases and government spending cuts, suggesting the underlying fundamental drivers of growth have likely improved.

In assessing growth in 2013, the second half of the year benefited from strong inventory accumulation. Such a rapid inventory buildup is likely unsustainable, so I expect some drawdown in inventories to contribute to a moderation of activity in the first quarter of 2014.

More importantly, however, I expect consumer spending and business investment, which together account for 80 percent of U.S. gross domestic product, to improve and support a pickup in private-sector spending growth. Low interest rates, steady improvements in the labor market, rising household wealth—including some wage gains—and a positive trend in consumer confidence are also likely to support an uptick in consumption and investment.

I also hope we move past some of the more pronounced fiscal uncertainty we have observed in recent years. Issues remain, such as health care reform and regulation, but debilitating debt-ceiling debates and government shutdowns are hopefully something the economy won't have to contend with in 2014.

In terms of labor markets, weather-related distortions appear to be diminishing given the most recent releases. In February, total nonfarm payroll employment rose by 175,000, quite close to its average pace throughout 2013, and in March, employers added 192,000 jobs. More broadly, we can see steady improvement in the labor market. For example, the unemployment rate, today at 6.7 percent, has fallen by almost a full percentage point over the past year—a rather rapid decline compared to historical averages.

Some of this drop in the unemployment rate is due to a decline in the labor force, though a broader measure of labor market underutilization—what economists call U-6—also has fallen rapidly. The U-6 measure, which includes part-time workers who would rather be working full time as well as discouraged workers and workers marginally attached to the labor force, declined the past year at its fastest pace on record.

As the labor market improves, firms are likely to have difficulty finding qualified workers. Good workers are always hard to find, and I often hear anecdotes from my private-sector contacts highlighting these challenges, especially in terms of matching skills to the job openings they have. This reflects in part a shift in the kind of jobs employers are seeking to fill—a shift we've seen over the past three decades. These employment trends have been the subject of research by economists at the Federal Reserve Bank of Kansas City that shows very interesting shifts in employment patterns between men and women. Women, in particular, have shifted into high-skilled jobs during that time.

Looking at more comprehensive measures, such as the National Federation of Independent Businesses' small business survey, we see some confirmation of these labor market issues. For example, firms are close to being more concerned about the quality of available labor than poor sales—conditions that are often consistent with more rapidly rising wages.

I have been encouraged by some measures showing signs that wages are moving higher. About one year ago, average hourly earnings were rising close to 1.5 percent year over year, but have trended up and are now running at 2.5 percent. In addition, the University of Michigan Consumers' survey in March reported that consumers are more optimistic now than at any time since 2008 that their personal income will increase in the year ahead.

In terms of consumer price inflation, I expect it to firm this year and gradually move up to the Fed's longer-term goal of 2 percent over the next few years. Several important factors are pointing to a gradual firming of inflation. Measures of inflation expectations are holding steady, the labor market continues to gradually normalize, and import prices—which were down sharply over the past year—are now stabilizing.

So with that backdrop, I expect economic growth of about 2.5 percent this year and expect we could see 3 percent next year, bringing further declines in unemployment rate.

Monetary policy and financial conditions

In March, the Federal Open Market Committee (FOMC) affirmed it would keep short-term interest rates near zero and reduced the pace at which its balance sheet is growing. Purchases of Treasury and mortgage securities continue to be substantial at $55 billion per month, despite $10 billion reductions at each of the last three FOMC meetings.

Although I dissented at seven meetings last year in my role as a voter on the FOMC, I did support the decision last December to begin reducing the amount of monthly bond purchases, which began in September 2012. And going forward, while I do not have an FOMC vote in 2014, I support further reductions in the pace of asset purchases as we take steps toward policy normalization.

Of course, regarding interest rates, the public is anxious to know, "When will rates go up?" and "When they do, how fast will they rise?"

To address the first question, the Committee modified its guidance about the future path of the target federal funds rate. With the unemployment rate nearing 6½ percent—the previous threshold for considering a rate increase—the Committee in March adopted more qualitative guidance. Instead of using thresholds or other quantitative measures, the Committee indicated that it likely will be appropriate to maintain near zero short-term interest rates for a considerable time after the asset purchase program ends, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal, provided that longer-term inflation expectations remain well-anchored.

Regarding how quickly rates might rise, the Committee also provided guidance about how policy would be adjusted after the eventual lift-off of the federal funds rate from its current exceptionally low level. The Committee anticipates that, even after employment and

inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run. I would note that the central tendencies of the Committee's Summary of Economic Projections indicate that, by 2016, both inflation and the unemployment rate will be near their longer-run projections. Yet, the median projection for the federal funds rate at the end of 2016 is just 2¼ percent.

While I support the move to more qualitative guidance about the future stance of policy, and agree that removing accommodation will require a gradual approach, I continue to be concerned that interest rates could remain too low for too long. We have seen in the past that overly accommodative monetary policy can adversely affect the market's ability to price risk, leading to the misallocation of credit.

To be clear, the goal of zero interest rates and quantitative easing is to boost economic growth. But these policy settings also carry risks to long-term financial stability and stable growth.

Froth in various pockets of the financial sector deserves ongoing monitoring, particularly in high-yield bond issuance and leveraged lending. For example, the Federal Reserve's recent Senior Loan Officer Opinion Survey suggests that recent guidance on leveraged lending will likely do little to curtail or significantly alter affected firms, as they will likely be able to secure funding from other sources.

As another example, the spread of 10-year BBB corporate yields has trended lower and has recently fallen to a post-recession low. The current spread is still greater than before the crisis, but we certainly shouldn't take that as a benchmark. I see this as another factor suggesting investors are taking more risk in a response to the low-rate environment.

Bankers are also telling me about fierce competition among lenders that often results in questionable terms and underwriting standards. As an example, I would note that consumer credit growth is beginning to accelerate, up nearly $300 billion in the second half of 2013—not including student loans. Some of this goes hand-in-hand with an improving housing market, but if you look carefully at the data, it is the least-creditworthy households that are more actively increasing their debt burdens.

I recognize that identifying all these risks and quantifying their impact today remains difficult. But, we should not underestimate their effects or ability to surprise, as recent history has shown.

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