# The Outlook and Monetary Policy

Esther L. George
President and Chief Executive Officer
Federal Reserve Bank of Kansas City

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*"It seems rather striking that one of the ideas now firmly imbedded in our articles of material faith, the concept of governmental responsibility for moderating economic gyrations, is almost entirely a product of our own Twentieth Century.*

*"This concept, which is steadily being brought into sharper focus, has evolved from general reaction to a succession of material crises heavy in human hardship. It grew from mass desperation and demand for protection from economic disasters beyond individual control.*

*"The Federal Reserve System, which I have the honor to represent, was our earliest institutional response to such a demand. It emerged out of the urgent need to prevent recurrences of such disasters as the money panic of 1907, and out of the thought that the Government had a definite responsibility to prevent financial crises and should utilize all its powers to do so.*

*"Accordingly, ... Congress entrusted to the Federal Reserve System responsibility for managing the money supply. This was a historic and revolutionary step. In framing the Federal Reserve Act great care was taken to safeguard this money management from improper interference by either private or political interests. That is why we talk about the overriding importance of maintaining our independence. Hence we have our system of regional banks headed up by a coordinating Board in Washington intended to have only that degree of centralized authority required to discharge effectively a national policy. This constitutes, as those of you in this audience recognize, a blending of public interest and private enterprise uniquely American in character. Too few of us adequately recognize or adequately salute the genius of the framers of our central banking system in providing this organizational bulwark of private banking and business.*

*"Since the Federal Reserve System came into being, the problems of inelasticity of currency and immobility of bank reserves -- which so often showed up as shortages of currency or credit in times of critical need -- have been eliminated, and money panics have largely disappeared.*

*"In this specialized respect there can be no doubt that the System has made notable progress, but in the more fundamental role of stabilizing the economy the record is not so clear. All of us in the System are bending our best efforts to capitalize on the experience of the past, and our current knowledge of money, so as to make as large a contribution as possible in this direction. But a note should be made here that, while money policy can do a great deal, it is by no means all powerful. In other words, we should not place too heavy a burden on monetary policy. It must be accompanied by appropriate fiscal and budgetary measures if we are to achieve our aim of stable progress. If we ask too much of monetary policy we will not only fail but we will also discredit this useful, and indeed indispensable, tool for shaping our economic development."*[1]

I'll pause here to give credit to former Federal Reserve Chairman William McChesney Martin, who delivered these remarks on October 19, 1955. His remarks more than six decades ago remain relevant today and in particular echo my own concern that the public has come to expect that monetary policy can solve for every problem that ails the U.S. economy.

I am here in York, Nebraska, with members of our Omaha Branch office board of directors, who serve as important windows on the current economic landscape. Those

[1] Addresss of William McChesney Martin, before the New York Group of the Investment Bankers Association of America, Waldorf Astoria Hotel, New York City, Oct. 19, 1955

insights are enormously valuable to me as I make my own assessments of the economy and form my policy views as a member of the Federal Open Market Committee (FOMC).

This evening, I'll offer you my thoughts on the state of the economy and current stance of monetary policy. As you may know, I did not agree with the Committee's decision to hold rates steady at the most recent policy meeting last month. I'll explain my views about policy, noting these are my own views and are not necessarily representative of others in the Federal Reserve System.

**The Economic Outlook**

Here in Nebraska, a state with a significant agricultural profile, the economy has softened, as Nathan noted earlier in his remarks. Across much of our region, the downdraft in commodity prices, combined with a strong dollar, has had a chilling effect on the regional economy.

Farm income is expected to weaken modestly in 2016, which would mark a third consecutive year in the current downturn. As lower income reduces cash flows, demand for credit among farmers has continued to rise. At this stage, the delinquency rate on agricultural production loans remains well below levels from five years ago, and farmland values, which are a significant contributor to the health of farm balance sheets, have remained relatively stable. Should these values erode further, we might expect to see further stresses on the agricultural sector.

Likewise, the dramatic fall in oil and gas prices over the past 18 months has negatively affected the region. The number of active oil and gas rigs in the United States has fallen by three-quarters, from almost 2,000 rigs at the peak to less than 500 today.

Weakness in energy-related investment has spread to upstream suppliers in manufacturing sectors, resulting in broader signs of slowing capital investment across the nation.

Credit conditions have tightened for energy-related companies, and strains on the earnings are leading to substantial job losses, particularly within our region, which includes Oklahoma and Wyoming. The challenges facing those affected are substantial, although we do see that some of these workers are finding employment more easily than they did during the last oil price shock.[2]

Beyond these sectors, the U.S. economy as a whole has continued to expand, and it has been quite a long economic expansion by historical standards. Indeed, the FOMC viewed the economy as sufficiently sound last December to warrant increasing short-term interest rates.

Since the December meeting, economic data have largely confirmed an outlook for further growth. We have received four strong labor reports as well as data showing that inflation is moving higher.

Unfortunately, however, the initiation of raising interest rates coincided with what appears to be a more vulnerable global economy, and a domestic economy that appears to be slowing in the first quarter and is threatened by markets that are anxious, uncertain, and volatile. Faced with these dynamics, the Federal Reserve's decisions to continue to normalize its policy settings have become more difficult.

In the face of such headwinds and uncertainty, the FOMC is guided by a focus on longer-run objectives—those objectives outlined by Congress in the Federal Reserve Act

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[2] Brown, Jason and Andres Kodaka, "The Reallocation of Energy-Sector Workers after Oil Price Booms and Busts," Federal Reserve Bank of Kansas City, The *Macro Bulletin,* March 3, 2016.

and expressed by the FOMC in its annual Longer Run Goals and Monetary Policy Strategy: "*The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates.*"[3]

Although financial markets were off to a volatile start this year, economic fundamentals remain relatively strong, particularly conditions in the labor market. More jobs were added in both 2014 and 2015 than in any other year since the late 1990s. This trend has continued with the economy adding an average of more than 200,000 net new jobs per month in 2016. The ongoing strength in job gains is well above the trend rate needed to absorb new entrants into the labor force. As a result, we have seen people who had been on the sidelines and not working over the past five years start to re-enter the labor force. And even as people have returned to the labor market, job growth has been strong enough so that the unemployment rate continued to fall over the last year. At 5.0 percent, the unemployment rate is quite close to the longer-run estimate of normal.

In addition to a healthy labor market, consumer spending has been supported by stronger household balance sheets. There are, of course, exceptions, but overall, household budgets generally look far less extended today than they did in the mid-2000s. The debt service ratio, which measures the burden of debt payments relative to income, is also lower than at any other time since the Federal Reserve started collecting data on this measure in 1980.

[3] Section 2A of the Federal Reserve Act as amended by the Federal Reserve Reform Act of 1977.

Household balance sheets also have benefited from housing prices. On a national basis, prices are close to where they were prior to the crisis. The supply of homes remains quite limited, relative to the total number of households, and is the lowest it's been for more than 40 years.[4] This combination of limited inventory, robust job growth and low interest rates will likely support continued home price appreciation. Those positive conditions will remain tempered by other factors weighing on housing. Credit conditions remain tighter than before the crisis, and bankers tell me new mortgage application procedures pose some challenges in moving borrowers through the financing process.

Overall, I view the health of household balance sheets and robust job growth as providing a foundation for consumer spending to continue making steady contributions to economic growth. This should allow GDP growth to continue near 2 percent, which I view as consistent with the economy's long-run potential.

With an unemployment rate of 5.0 percent, the economy is near full employment. Measures of inflation appear to reflect stable prices with upward movement in core PCE inflation year-over-year (from 1.3 percent to 1.7 percent over the past three months). In the interest of objectives to promote long-run sustainable growth with healthy employment and price stability, I believe monetary policy should respond to these developments by slowly removing accommodation.

## The Current Stance of Monetary Policy

Today, monetary policy can be viewed as highly accommodative for three reasons. First, the current federal funds target range of between 0.25 percent to 0.5

[4] Rappaport, Jordan, "The Limited Supply of Homes," Federal Reserve Bank of Kansas City, The *Macro Bulletin*, March 23, 2016.

percent is quite far from the fed funds' long-run level, which the FOMC views at around 3.25%. Second, the FOMC has signaled that the fed funds rate will be raised only gradually. And third, the Fed continues to hold a $4.2 trillion balance sheet, which has the effect of keeping longer-term interest rates low.

Years of experience, evidence and research remind us that monetary policy is most effective when used as a counter-cyclical tool. That means providing policy accommodation when deteriorating economic conditions threaten price stability and employment. Conversely, it means unwinding accommodation as we see economic conditions improve. In other words, the Fed should cut rates when the economy stumbles or contracts, and raise rates as the economy recovers and grows.

## **The Limits of Monetary Policy**

While monetary policy can be an effective counter-cyclical tool, it is by no means a counter-*structural* tool. That is, monetary policy can work to smooth out some of the ups and downs in economic activity, but can do little to push the trend rate of growth higher. Any persistent attempts to do so will likely prove futile, as longer-run growth is driven by real factors like population growth, productivity and the accumulation of capital, both human capital from educational attainment and physical capital from business investment.

The FOMC has acknowledged that economic conditions will likely warrant a gradual pace of policy adjustments. I support that approach. A gradual path allows us to take into account various headwinds and risks faced by the economy, and to proceed in a manner that maintains policy settings that are—and will continue to be for some time—very accommodative.

While I view the gradual approach as appropriate, postponing the removal of accommodation when the economy is near full employment and inflation is rising toward the 2 percent target could promote alternative risks that would decrease the likelihood of achieving our longer-run objectives. In the long run, a failure to keep interest rate policy in line with improving fundamentals can distort the allocation of capital toward less fruitful—or perhaps excessively risky—endeavors. Within the last two decades we have faced episodes of accelerating equity prices, housing prices and, most recently, commodity prices. Currently, commercial real estate markets, where prices have continued to drift higher, bear watching. When these types of imbalances tip, the entire economy can face the consequences of their fallout, with some sectors and populations more impacted than others. My concern for some time has been that extending monetary policy too far beyond its scope of capability risks undesirable financial, economic and political distortions.

In the current environment, waiting to make additional adjustments to monetary policy may seem costless in the face of benign inflation pressures. Some argue that we have the ability to make more rapid adjustments later if inflation moves higher than currently projected. From a technical standpoint, it is true that the Fed has the ability to steer short-term rates and could raise them quickly if needed. But such actions are likely to be costly, inducing financial market volatility and slowing economic activity. Historically, rapid increases in interest rates end poorly, resulting in economic recessions.

**Conclusion**

Staying the course with a gradual path of policy normalization is warranted in my view. Removing accommodation in small doses is consistent with the economy's fundamentals, keeps policy accommodative while global and domestic risks play out, and does not preclude pausing or responding if downside risks materialize.