THE *SHIFTING* NEXUS OF
GLOBAL AGRICULTURE
FEDERAL RESERVE BANK *of* KANSAS CITY • JULY 16-17, 2013

Keynote Address:

Economic Conditions and Agriculture

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When I come to think of it, I probably learned more of my life lessons on the farm than anything I've done to date. Let me welcome you all this afternoon. I am delighted to see a full room on such an important topic.

Our symposium for the next two days is really an ambitious one. And it has been focused importantly on a range of topics, so we have named this event, "The Shifting Nexus of Global Agriculture." We're going to cover ground that ranges from looking at farm productivity to infrastructure investment and, of course, the future of agricultural markets.

As you might guess, given the importance of agriculture in our district economy, the Federal Reserve Bank of Kansas City has long made research and analysis in the area of agriculture a priority for our Bank and made important contributions to monetary policy with that insight. Our program today is going to continue that tradition.

I should mention that as president of the Kansas City Fed, we have several operations that are going on here in our region and my responsibilities extend to each of those operations. Today I am going to focus on my responsibilities as it relates to the conduct of monetary policy and I will be offering my views on the current state of the U.S. economy and how I see Fed policy.

As you know, I am one of 19 participants on the Federal Open Market Committee. This year I am a voting member of that Committee. You are probably also aware that my views have differed from the majority of the voting members on the benefits of our unconventional policy actions, but I continue to believe that a diversity of views on that Committee is an essential feature of both policymaking and the Federal Reserve's inherent design and structure.

Let me turn to some of my thoughts on how the nation's economy is unfolding. I should note, as it relates to the Tenth District and what I see going on in my regional economy, agriculture, and frankly energy, have been very powerful engines in this recovery for this region's economy. The effects have been very important contributors to the nature of the recovery that we have seen in this part of the country.

Recovery, of course, though in the broader economy has not been as strong. Frankly, the labor markets in the United States have struggled greatly during this recovery. Just as our agricultural sector has faced challenges recently with drought and commodity price volatility, the broader economy also has faced a number of challenges. Over the past four years, financial stress has spiked at various times, due primarily to events abroad. More recently, U.S. fiscal policy is now weighing on current growth.

Despite these occasional setbacks, the economy has continued to heal, showing signs of steady progress in a number of areas. Of particular importance – and I will focus on these two today – the labor market and the housing sector are finally showing more convincing signs that, in my view, we are on a steady and sustainable growth path. With the unemployment rate still high – 7.6 percent four years into a recovery – the overall assessment of our economy has rested heavily on labor market data and trends. So it is encouraging that we have seen steady signs of improvement.

Employment has increased by an average of slightly more than 200,000 jobs per month over the past six months. And measures of labor market slack have been steadily declining since 2010. An especially good sign, I think, is the recovery in the labor market has breadth, as far as industries continue to add jobs that are reducing unemployment. So this broad base of hiring is quite reassuring.

We've also seen indicators of things like quit rates, which have moved higher over the past year across a number of sectors. A high voluntary quit rate suggests that workers are increasingly finding better labor opportunities, so they are voluntarily changing jobs. Historically, this has been an indicator that has given us a sign that labor markets are improving.

The layoff and discharge rate has also moved lower and remains near its 10-year low. Taken together, these observations suggest that, while we still see a fair amount of slack in the labor market, the overall trends are quite positive.

Likewise the housing sector has been showing steady signs of improvement, as well. The epicenter of our financial crisis, as you know, housing suffered a major blow. The recovery now is important, in my view, for a number of reasons.

First, as we see rising house prices, this increases household wealth and so it aids in the repair of household balance sheets. Secondly, as the housing recovery continues, hiring is likely to increase in areas like construction and construction-related industries. And third, increased housing activity has what I call knock-on effects that result in higher demand for services related to the

housing sector, such as the services of realtors and appraisers. Households are also likely to purchase larger ticket durable goods, such as appliances, when moving into a new house. All of these factors combined point to the important role of housing in our economy. So its long-awaited improvement is a welcomed development.

Although the general trends for housing and the labor market are positive, I expect the economy's rate of growth this year is going to be tempered for a couple of reasons. Fiscal tightening, for example, is likely to shave about 1½ percentage points off growth this year. And the economies of some of our key trading partners – such as Europe – remain sluggish. With these headwinds, I anticipate real GDP growth this year is going to be somewhere around 2 percent, driven largely by improvements in the labor market and housing.

When you look at these positive developments, they are notable because they affect how we judge the appropriate stance of monetary policy. Since September of last year, the FOMC has been aggressive in providing monetary accommodation through its large-scale asset purchases. Also known as quantitative easing, these purchases, buying $40 billion a month in agency mortgage-backed securities and another $45 billion of Treasuries, have been explicitly tied to the outlook for the labor market.

So the question is, "Has the outlook for the labor market improved?" And I am going to offer you some data that suggest that it has. If you look at the projections that are supplied by the 19 participants on the FOMC, you would see that last September the unemployment rate was expected to be about 7¾ percent in the fourth quarter of this year.

The most recent set of projections, however, now foresees an unemployment rate of about 7¼ percent, which is half a percentage point lower than we saw last September. This is also true if you look at private-sector forecasters, such as those from the Survey of Professional Forecasters. You will note they are also are taking on additional improvements. So those private forecasts for unemployment last year have also fallen about a full half percentage point since last September.

In addition to the projected decline in that unemployment rate forecast, the projections of FOMC members suggest more confidence, on average, about improvement in the labor market. Last September you would have seen FOMC projections for the unemployment rate at the end of 2014 showing the difference between the highest and lowest projections of well over 1 percent, so there was a fairly significant gap. Most recently, that difference has narrowed and is now slightly

more than half a percentage point. The smaller difference suggests members of the FOMC are in closer agreement about the improved outlook for the labor market.

What is the next phase for monetary policy? If you look over the past five years, the Federal Reserve has added more than $2 trillion in Treasuries and agency mortgage-backed securities to its balance sheet and continues today to add $85 billion each month. The results of these actions have been to influence asset prices and support financial markets, and these actions have been supported by a majority of the Committee for these benefits.

I have been more skeptical that the real economy has benefited sufficiently to warrant the risk I see associated with such aggressive easing during a sustained recovery. Markets are now beginning to adjust to the reality that such support cannot last indefinitely. In fact, yields had begun to rise in early May, well ahead of the FOMC's last meeting where in the press conference following that meeting Chairman Bernanke indicated it would be appropriate to moderate the monthly pace of purchases later this year.

Given the ongoing improvement in the labor market, I have been advocating for such an approach during my time this year as a voting member on the Committee. And I continue to see this as an appropriate next step for monetary policy. Specifically, I would like to see the FOMC begin to systematically reduce the pace of purchases in a manner that brings the program to an end sometime during the first half of next year.

Reducing the pace of purchases, I'll remind people, continues to add accommodation, but it does provide a gradual adjustment process, I think, for financial markets. Still, financial markets have reacted to the realization that the pace of purchases is likely to slow in the months ahead, causing longer term interest rates to be more volatile and move higher. Yet the economy is positioned, in my view, to benefit from modestly higher, longer term interest rates. For example, bank net interest margins can improve over time, without having to resort to increasing the amount of risk they take on their balance sheet, thereby supporting financial stability. In addition, retirees and savers who rely on fixed-income investments can over time begin to realize improved returns.

Of course, markets and the public want to know more than just the next step for asset purchases, since longer term interest rates also depend on the entire expected path for short-term interest rates. Sound monetary policy rests on systematic reactions to the economy that are well understood and anticipated by the public.

In other words, the public should have some understanding of how the FOMC intends to adjust policy in the future. If the unemployment rate falls as expected and inflation moves toward the 2 percent goal, then reducing the pace of purchases in September and ending them next year is appropriate. Of course, the Committee's forecasts have often been too pessimistic about the unemployment rate. That is, the unemployment rate has generally fallen faster than we've expected. If this were to occur in the context of a firmer inflation outlook, then it may be appropriate to reduce the pace of purchases more quickly than I've suggested.

The other unconventional aspect of the Fed's policy has utilized something we call *forward guidance*, which is currently in the form of setting thresholds. Thresholds indicate that short-term interest rates are likely to remain at their current level, which is near zero, as long as the unemployment rate is about 6½ percent and the inflation forecast does not move higher than 2½ percent.

Why are thresholds being used? One reason is that interest rates must be positive, so we can't actually push them below zero. As a substitute, policymakers can guide the public and markets to expect interest rates will stay lower for a longer period than perhaps they originally expected. The impact of this forward guidance, then, is that it lowers longer term rates, which supports interest-sensitive sectors of our economy, such as housing and autos.

As asset purchases wind down, the next phase of policy will depend on these thresholds. My own view is that these thresholds should act similar to triggers. Once the employment rate nears 6½ percent, markets and the public should expect lift off of short-term interest rates.

My view, though, differs from how thresholds are currently used by the FOMC. The FOMC has continued to view these thresholds as only a prerequisite to considering the possibility of raising rates, but not necessarily to signal an actual increase. That is, 6½ percent for the unemployment rate is not, as the Committee has defined it, necessarily a trigger.

The distinction between this threshold and an actual trigger, I think, is important. Thresholds provide continued discretion to the Committee about raising rates once the unemployment rate falls below 6½ percent, and therefore have the potential to perpetuate uncertainty about where and when rates will increase. In contrast, a trigger resembles more of a rule and can provide firmer guidance and certainty, in my view, to the public and markets about when rates are likely to first increase.

Let me close by saying that I see the progression of this recovery and the gradual movement toward a more normal interest rate environment as welcomed developments. Recent communications about the Federal Reserve's asset purchases are an important first step toward normalizing rates. And, although adjustments of this sort are often accompanied by some volatility, I am reminded that it is a necessary step if the FOMC is to fulfill its Congressional mandate to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates. Thank you.

I think we have time for some questions, so I would be delighted to hear your questions, your comments as well and, as I tell people, I'm always open to your advice.

Alister Bull, *Reuters*: Thanks for taking my question. Do you see evidence of a housing bubble or an asset bubble developing and does that influence your decision to end asset purchases?

Esther George: I have, for some time, expressed concern about the distortions that can be created by zero interest rates and the Fed's asset purchases on the stability in the entire system. The evidence we see of that I'm always reluctant to call a bubble, because we know that it is very hard to see bubbles. We know that sometimes the evidence we see of things related to instability work a bit like icebergs. Things can be below the surface that are less obvious to us.

But I do know that when interest rates are at this very, very low level and the very design of our asset purchase program is to push people away from safe assets and to riskier assets, it creates the conditions by which you can see risk begin to grow. So we have seen areas that are very sensitive to this in the leveraged lending market, in REITs, other aspects that suggest this low cost of money can lead to the kind of risk-taking that can be destabilizing.

Are there bubbles? I don't know. I don't know how to call a bubble. I can tell you when I see things that look to be moving in a direction that is off trend, maybe there is the potential for that. So I have raised this as a risk of the current policy in terms of the long-term sustainable growth we all want for the U.S. economy that we not see destabilizing effects from our current policies.

______________________: On the impact of global markets and the softness that we may see there, how does that come back and how does that play into monetary policy?

Esther George: It's a very good question. Of course, the very measure of growth in the U.S. economy looks carefully at the export activity we have. We have seen softness there, as Europe, which is a key trading partner, has experienced its own recession and is struggling with growth.

It is very much factored into thinking about the long-term growth potential to understand what is happening globally. Increasingly, the effects of global actions are felt, whether they are here or around the world. We see that from central bank monetary policy to structural issues in various economies. So clearly it is an important factor in how we think about growth projections and how we build those in.

My sense is that Europe has stabilized a bit. We are looking to see whether growth will resume next year in some fashion that will be favorable for our own growth. Of course, we are constantly looking at the data to see whether we should shift gears in terms of how we think about that. Thank you.

______________________: Given some of the structural issues we see in the labor market, have you been too optimistic in how you have regarded the improvements we have seen, particularly when you see more part-time workers coming on board?

Esther George: That is a very good question. I should say at the outset, and as I noted, the unemployment rate is still high. My concern, as I look at the labor markets, is not to suggest they are back to where we want them to be, but it is to raise the prospect that monetary policy has limits to what it can do to influence these labor markets. The effects we can create influence conditions around labor markets.

There are many nonmonetary factors that will influence the long-term direction for the labor markets. Continuing to provide aggressive accommodation, I have raised the question of whether that doesn't raise more risk relative to what can be accomplished. I think we are seeing these improvements. Right now the rates at which we are seeing changes in the labor markets suggest that adding jobs around 150,000 to 200,000 a month is enough to take care of population growth in the country, as well as to begin to pick up unemployed workers.

I expect more and more that we will need time to see these labor markets heal. This, of course, will be a challenge for policymakers in judging how much accommodation can continue to influence that going forward. Your point is well-taken.

Dan Swearengen, College of the Ozarks: In recoveries in the past, many times we've had growth rates in our economy of 3 percent or more. Are you satisfied with 2 percent? Are we getting to a point where 2 percent is good enough? What are your thoughts on that?

Esther George: That is a very good question. In past recoveries, we've seen higher rates of growth. The question was, "Are we satisfied with 2 percent?" The answer is, "Not satisfied but trying to be realistic." Given the nature of this financial crisis, we should not expect this is a typical recovery. I think – given the depths of the recession, the financial damage, the amount of leverage in the economy – that seeing 2 percent growth is a positive. Is that the long-run potential for an economy? I don't know. I am optimistic about the factors that influence this economy. Once we get through the deleveraging process, the fiscal headwinds that face us, and some of the global issues, we will begin to see stronger rates of growth, even as early as 2014, that suggest the economy has the capacity to continue to grow.

Ryan Connors, Janney Montgomery Scott: You reference agriculture and energy as a significant part of your District economy. What has been the role of monetary policy on these sectors?

Esther George: Without question, the national span of monetary policy of course affects broadly many industries and many markets. When I meet with businesses in the agriculture and energy sectors, they note the influence of some of these policies, sometimes in a riskier way, in terms of the cost of capital in influencing decisions they make, but also sometimes noting that monetary policy is not able to affect some of the decisions that affect their own investment decisions. For example, the regulatory environment looking at fiscal issues, tax policy, and other things have powerful influences on their decision to invest, aside from the current interest rate environment.

Certainly, monetary policy has broadly affected the economy. We see that in mortgage rates and we see that in auto lending. But there are many factors that have influenced these two particular sectors in terms of the growth they've seen.

One of the things I've talked about is agricultural land values and the really extraordinary levels at which we see sales continuing to occur in markets in this region. What is driving this? Certainly we know that global demand of the commodities has driven the values there. We also know that looking for return can be a contributor to some of that value, as well.

Marcia Taylor, DTN, The Progressive Farmer: Many farmers remember the Federal Reserve policies in 1979 to the early 1980s as being inflation-fighting years. They were also years

that led to big changes in land values and what we call "The Farm Credit Crisis." How would you see this ending? Is it likely that farmers need to fear a disruption of that level occurring again?

Esther George: That is a very good question. It's one I think about a fair amount, because I lived through that time and saw the implications. You might look at today's landscape and note the amount of leverage we saw in 1970s in the farm sector seems to be absent today. I chalk that up to some lessons learned. You will find some of our agricultural banks clearly remember some of the issues they faced with collateral-based lending. So, in the banking industry, you do not see the levels of leverage that characterized what we saw then. It made the farms very vulnerable to the correction they saw then.

The question it raises, though, as you begin to see the capacity, there is a lot of cash. You see more equity going into some of these deals. But also to understand, what is the margin here that continues to make these farms operate on a successful level? We have seen some very large consolidated operations that developed exposures, not just bank lending but in some cases vendor financing in other places that still were subject to the dynamics of the margins they maintained, the management of those processes. So the run-up in land values is likely to still create issues for those who are exposed in some way.

Do we see it broadly as we did in the 1970s? Not the same scenario, but the implications – just like we saw for example in a tech bubble that was not leveraged, and collapsed, you will still see some fallout if there is a strong correction in any of these asset values.

Well, let me thank you once again for being here. You have what I think is going to be a really interesting, meaty program ahead of you. I want to thank our speakers who have joined us to bring this program together and wish you all the best over the next day and a half. Thank you.