Monetary Policy for the Near and Long Term

Remarks by

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

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Thank you. I appreciate the opportunity to join you here this evening.

The Tenth Federal Reserve District covers a very large geography and keeping tabs on economic conditions in the region is an important aspect of my work. Fortunately, I have a small group of economists at the Bank who conduct research, analyze data and survey key sectors of the economy, but I also rely on individuals across the region who serve on our various boards and advisory groups. The input and perspective of these individuals and other contacts are key to our understanding of the economic conditions and emerging risks facing our region and the nation. Their contributions help to shape my views as I represent my region at the Federal Open Market Committee (FOMC). In fact, there are a number of individuals from the Wichita area who assist the Federal Reserve in this way, and I would like to take a moment to acknowledge them.

Trish Minard with Southwest National Bank here in Wichita, Kan., recently joined the Kansas City Fed's Board of Directors. Although the Federal Reserve Board of Governors in Washington, D.C., has oversight responsibilities for the 12 regional Federal Reserve Banks, each Bank also operates under the leadership of a Board of Directors. This structure was designed by Congress to carefully balance public and private interests in the oversight of the nation's central bank. The goal was to ensure broad representation in the Fed's important policy deliberations with ample opportunity for discussion and disagreement, while also providing insulation from those who might seek to influence policy decisions for short-term political gain. As a result, the individuals who serve on our board have a very important responsibility within the Fed's structure.

Dan Solomon, chief financial officer of Koch Chemical Technology Group, has been involved with our Economic Advisory Council for several years, and I have appreciated his insights on regional, national and global economic trends.

I'd also like to recognize Michael DeBroeck, senior vice president with Intrust Bank, and Bob Thurman, chief executive officer of Credit Union of America, who have served on our Payments Advisory Group. Additionally, Steve Radley, president of NetWork Kansas in Andover, serves as a member of our Community Development Advisory Council – a group that regularly informs and advises us on conditions in low-, and moderate-income communities. My thanks to each of these individuals for their service to the Kansas City Fed and for the contributions they make to monetary policy deliberations.

We have a lot going at the Fed right now. At last week's FOMC meeting, we said our farewells to Janet Yellen, whose term as Fed chair has ended. And on Monday of this week, Jay Powell took the oath of office as the Fed's new chairman. He is an experienced Fed governor whose service on the Board of Governors began in 2012. Having worked with him the past several years, I think you can expect that Fed policy will continue along its current path, and I expect a smooth transition.

Of course, this week's headlines have been focused on the market's reaction to last Friday's employment report and potential inflation risks. So, this evening, I'll share with you my views on the outlook for the nation's economy and the challenges ahead for the Federal Open Market Committee over the near- and longer-term. I'll plan to leave time at the end of my remarks to take your questions, comments or advice.

Before continuing, now would be a good time to remind you that the views I express this evening are my own and not those of the Federal Reserve System or the Federal Open Market Committee.

Current economic conditions

The fundamentals of the U.S. economy are sound. Preliminary estimates suggest that real GDP — our broadest measure of economic activity — grew at an annual rate of just under 3 percent in the second half of last year with robust consumer activity and a solid increase in business spending on fixed investment.

This current expansion has been a long one and it has drawn millions of Americans into the workforce as labor markets have strengthened. The unemployment rate has fallen to a historically low 4.1 percent. Here in Wichita, labor market conditions are somewhat tighter with the unemployment rate at 3.8 percent.

Hiring remains solid with payroll employment gains averaging 192,000 per month over the last three months. But the pace of payroll gains has been gradually slowing since the peak in 2014, and I expect those numbers will decelerate further as labor markets continue to tighten and firms find filling job openings increasingly difficult.

As labor markets have tightened, compensation for workers has increased. This is a welcome development because wage growth has been fairly modest through much of the current expansion.

Another favorable aspect of the current expansion is that inflation has remained low even as the economy has experienced above-trend growth and a tightening job market. This has helped workers by allowing wage increases to outpace inflation. Year-over-year inflation is currently running just under the Federal Reserve's objective of 2 percent, although I expect it will begin to rise as labor markets tighten further and global demand pushes up import prices.

Taken together, these current conditions and the near-term outlook appear quite rosy. You might think in a scenario like this, Federal Reserve policymakers would have an opportunity to relax a bit. Unfortunately, that is not the case.

Near-term challenges

Although the financial crisis is now well behind us, and we have largely achieved our objectives for employment and inflation, the stance of monetary policy remains quite accommodative. The federal funds rate, which is the overnight interest rate we target, remains well below estimates of its longer-run value of around 3 percent.

In addition, the Federal Reserve's balance sheet remains extraordinarily large by historical standards due to the FOMC's large-scale purchases of longer-term Treasury and agency debt beginning in 2007. These programs, commonly referred to as quantitative easing or QE, ended in October 2014 and the process of shrinking the Fed's balance sheet to reduce these holdings started last fall. By the end of this year, only about a quarter of the increase to the Fed's balance sheet resulting from the first round of large scale asset purchases will be unwound.

As monetary policy accommodation is gradually withdrawn, the economy is getting a boost from fiscal policy related to the recent tax bill. How much of a boost is hard to tell at this stage.

In our surveys of manufacturers across our District, the expectations of future activity have increased since the bill was signed. This is potentially good news for Wichita, where the economy is heavily reliant on manufacturing, a sector that experienced a net job loss last year.

Overall, I expect that lower personal tax rates will boost aggregate demand, and that a lower corporate tax rate and the more favorable tax treatment of investment spending will increase aggregate supply, although it is difficult to predict exactly how and when consumers and businesses will respond.

The result is that an uncertain degree of fiscal stimulus is arriving at the same time the economy is operating at or beyond full employment and monetary policy remains accommodative. And because of that, it is important that the FOMC continues on its current path of policy normalization with gradual increases in the target federal funds rate. The median projection from the FOMC's Summary of Economic Projections calls for about three, 25 basis point hikes in the federal funds rate this year and about the same number next year. This is a reasonable baseline unless the outlook changes materially.

Longer-run challenges

While threading this policy needle will be a key challenge over the next couple of years, there are also a number of structural developments that could pose challenges over the longer run. The nature of these structural issues is beyond the scope of monetary policy to address, but they will nevertheless have implications for economic growth, employment and inflation and deserve careful monitoring.

Among these is the slowdown that we have seen over the last several years in the economy's potential growth rate. This is the rate of growth consistent with maintaining the Fed's dual mandate of price stability and full employment. By most estimates, this rate was falling before the financial crisis and is currently believed to be about one-half of what it was in the 1990s. This slowdown in the economy's potential growth stems from slower growth in the size of the potential workforce and the productivity of that workforce. Due largely to demographic changes, especially the retiring of the Baby Boom generation, the annual growth rate of our labor force is only a little better than one-third of what it was in the 1990s. At the same time, productivity growth is about one-half what it was in the 1990s. Both of these unfavorable trends are projected to persist over the next decade. While these projections are highly uncertain, if they prove accurate, we can expect, among other things, a slower rate of improvement in living standards relative to the pre-crisis period.

Slower potential growth also has some troubling implications from a monetary policy perspective. For one thing, it has led many economists to lower their estimate of the interest rate that is consistent with full employment and price stability. Currently, the FOMC's median projection for the longer-run federal funds rate is around 3 percent, which is considerably below what it was only a few years ago. This means that a future FOMC may have substantially less room to lower the federal funds rate should conditions warrant an increase in monetary stimulus. In such situations, for example a future recession, it might prove helpful for fiscal policy to step in and provide a countercyclical stimulus.

But that leads me to another structural challenge—the unsustainable trend of government debt. This will make it difficult for fiscal policy to play that countercyclical role.

The federal budget deficit increased as a share of GDP for the third straight year in fiscal 2017, and it was widely expected to creep higher over time even before the recent tax cuts. Demographic trends will raise government spending as an increasing share of the population receives retirement and health care benefits. Additionally, health care costs are projected to grow faster than the economy, as are the federal government's net interest costs.

In all, federal debt held by the public, which was equal to about 35 percent of GDP before the recession, is now up to 75 percent of GDP. It is projected to exceed its historical (WWII) peak of 106 percent by the 2030s, barring a shift in fiscal policy. The nation remains far from a fiscal crisis, but changes will be necessary to put government debt on a sustainable trajectory in the coming decades. The sooner these changes can be made, the less drastic they will need to be and the better positioned fiscal policy will be to take a more prominent counter-cyclical role in any future downturn.

Conclusion

In closing, over the longer run, demographic trends and sluggish productivity point to the possibility of slower economic growth and higher fiscal deficits. These structural developments have the potential to complicate monetary policy. If the neutral rate of interest remains historically low, monetary policy may have less scope to stimulate the economy in a downturn without again resorting to unconventional policies such as asset purchases. A natural response to such a situation would be to rely more heavily on fiscal policy. However, the longer-run fiscal outlook suggests that fiscal policy may be similarly constrained. Thus, it is critical that the longer-run budget issues associated with our aging population be addressed sooner rather than later.

In the near term, the good news is that the U.S. economy is currently growing at a moderate pace, with full employment and price stability. As always, some regions and industries are doing better than others but, on the whole, economic conditions are good. At the same time, monetary policy remains accommodative. To sustain the expansion without pushing the economy beyond its capacity limits and creating inflationary pressures, it will be important for the Federal Reserve to continue its gradual normalization of interest rates.