Central Bank Patience

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

Redlands Community College
El Reno, Oklahoma
April 4, 2013

Welcome remarks

Thank you for inviting me to El Reno. I've been in the role of Reserve Bank president for more than a year and have had many opportunities to meet with business and community leaders who offer important perspectives on the economy and credit conditions. This insight shapes my view of the regional and national economy and provides essential input to monetary policy during discussions at the Federal Open Market Committee (FOMC) meetings. This regional input, supported by the Federal Reserve System's structure, was designed to serve the public's trust, and I believe it enhances the effectiveness of policy. Certainly, these two days in El Reno have provided insightful perspectives on the local economy.

My remarks today will focus on an outlook for the US economy and my views on the current stance of monetary policy.

Private sector momentum, public sector headwinds

The U.S. economy continues to grow slowly. Growth has averaged slightly more than 2 percent over the past three years. At this pace, it is certainly less robust than other recoveries, but history does show that recoveries after a financial crisis are often slower. Importantly, despite a variety of headwinds during this four-year period, the economy continues to improve in several key aspects.

First, the pace of job growth has gradually been putting people back to work. The unemployment rate has declined from its peak of 10 percent late in 2009 to its current level of 7.7 percent. Over the past six months, private sector payroll gains have averaged 200,000 per month. This pace of growth is a positive development in labor market conditions and compares favorably to pre-recession levels. The average monthly increase in private employment from

2004 to 2006 was 168,000—a period when the housing bubble was fueling economic growth and job gains.

Likewise, the decline in new claims for unemployment insurance points to an improved labor market. Claims are historically volatile, but the four-week average number of claims is currently about 355,000 per week, which is near its lowest level in five years and almost half the level of the previous peak of 660,000 per week. This also compares favorably to the average number of weekly claims from the 2004 to 2006 period at 330,000 per week.

Importantly, these labor market improvements are helping to support consumer demand and confidence. Consumption has increased at a 3 percent annualized pace over the past six months, compared to the 2 percent pace since the end of the recession. Some of the improvement has come at the cost of a lower savings rate, but it also suggests consumers are adjusting to higher gasoline prices and lower take-home pay due to the expiration of the payroll tax holiday. Despite these headwinds, consumer spending has held up quite well in the first two months of 2013. Consumer sentiment also recently rebounded after falling sharply in mid-March with the assessment of current economic conditions at its highest level since the end of the recession.

The rebound in housing has likely contributed to this improved sentiment. Home prices have risen 8 percent over the past year as a result of low inventory levels, boosting household wealth and supporting consumption. With low inventories, homebuilders are responding by increasing construction activity. Housing starts are up more than 25 percent compared to a year ago, and housing has made a positive contribution to total growth for seven consecutive quarters.

Looking forward, I expect GDP growth this year will likely be about 2 percent and that the unemployment rate will continue to decline modestly by the end of the year. This pace of growth reflects the mandated federal spending cuts and the adjustments to the tax code at the end of last year. Uncertainty about fiscal policy and recurring fiscal deadlines, as well as the regulatory environment, is likely to continue the cautious attitude by businesses toward expanding capacity.

Monetary policy during and after the crisis

Last month marked the fifth anniversary of the collapse of the investment bank Bear Stearns, one of the tremors that announced the financial crisis. The Federal Reserve, along with other central banks, responded aggressively, providing liquidity to financial markets and monetary accommodation to cushion the decline in real economic activity. More than four years later, unprecedented levels of monetary policy accommodation continue.

At its March meeting, the FOMC decided to maintain its highly accommodative stance of monetary policy by continuing actions approved late last year. Specifically, the Committee agreed to continue purchasing $85 billion monthly in longer-term mortgage and Treasury securities until the outlook for the labor market has improved substantially. The size, pace and composition of the asset purchases will depend on an assessment of benefits and costs, as well as on the extent of progress toward the FOMC's economic objectives. Additionally, the FOMC affirmed that, provided the inflation outlook does not move above 2½ percent, it expects to keep the federal funds rate near zero until the unemployment rate reaches 6½ percent.

Efforts to speed up the recovery

Large-scale asset purchases and the commitment to keep short-term interest rates near zero for an extended period of time are intended to speed up economic growth and get people back to work more quickly. Keeping rates low for mortgages and auto loans, for example, can stimulate borrowing and encourage households and businesses to shift from safe assets to investments with more risk, such as corporate bonds and stocks. With high levels of unemployment and low inflation, a majority of FOMC members have judged such policies are warranted and that the benefits continue to outweigh any risks.

There is no question that high unemployment is costly to individuals and results in a loss of output relative to the economy's long-run potential. In the interest of promoting economic growth, monetary policy can, and has, played an important role in easing financial conditions as the economy recovers from the recent recession. Even so, continued use of "emergency" policies and an extended period of inordinately low rates carry significant risks. Because of those concerns, I have dissented at the last two FOMC meetings.

To be clear, I support an accommodative stance of monetary policy while the economy recovers and unemployment remains high. But I view the current policies as overly accommodative, causing distortions and posing risks to financial stability and long-term inflation expectations with the potential to compromise future growth. As the Fed's balance sheet continues to expand, the risks and costs increase in my view.

A key issue that concerns me is the incentives created by an extended period of zero rates. Typically, central bank actions to lower interest rates in response to a recession and boost aggregate demand are reversed relatively quickly, and rates return to more normal levels. In contrast, following this recession, zero interest rates have been in place for more than four years, combined with large-scale asset purchases and a communications program signaling an extended period of low rates. As a result, the yield curve has flattened, and 10-year rates have remained historically low.

Faced with this unprecedented rate environment, individual and institutional savers, smaller banks, insurance companies and pension funds are challenged to revamp their portfolios and products. Individuals and institutions are placing more emphasis on strategies that entail substantially greater risk as they move away from traditional investment-grade products towards riskier lending, non-investment-grade products or equities.

By design, zero interest rates push investors from “safe assets” into higher-risk assets and thereby encourage growth. Whether this increased risk proves healthy and supportive of economic activity, only time will judge. Some have argued that early signs of excessive risk-taking or overheating in specific sectors of the economy, such as farmland values, high-yield bonds or leveraged loans, can be effectively addressed by regulators or are not yet threatening to the broad economy.

For some time, concerns about the rapid rise in farmland values were discounted by the fact that significant leverage was not being used. The sharp rise in lending at the end of last year raises concerns that the wealth effect in agriculture could trigger a leverage cycle similar to past farm booms when farm incomes and asset values faded.

Certainly, I expect regulators will be focused on such risks and continue to use the supervisory tools available to them, such as the recent guidance issued on leveraged lending. However, as we learned from this most recent crisis, emerging risks can be hard to judge and it can be even harder to determine what action should be taken ahead of any obvious or near-term threat. In addition, riskier financial activity can grow outside the regulated sector. For these reasons, asking bank regulators and supervisors, or the newly-tasked monitors of financial stability, to single-handedly identify and contain the risks introduced by a highly accommodative monetary policy is not realistic.

Likewise, I am concerned that with the adoption of thresholds for inflation and unemployment, the FOMC has expressed some tolerance for having the inflation outlook exceed 2 percent. A willingness to let inflation rise above its long-term goal carries the risk that longer-term inflation expectations rise above the Committee's 2 percent goal, as well. The current pace and composition of asset purchases also could put the stability of inflation expectations at risk, if markets perceive that the size of the Fed's balance sheet could complicate the return to a more neutral monetary policy stance. The FOMC's exit strategy – the process of reducing the size of the Fed's balance sheet and returning short-term rates to their neutral level—will likely begin only well into the future. But the strategy will need to be carefully executed to minimize market disruptions that could cause longer-term interest rates to suddenly rise.

Patience for the long run

The economy is making progress in recovering from a deep recession. I have acknowledged the important role that low rates must play in supporting this recovery even as I have raised significant concerns about the current stance of zero interest rates for an extended period. Can efforts to speed up the pace of growth with untested monetary policy tools be effective? The FOMC is carefully considering such issues and believes the risks are worth taking. However, our limited understanding of the possible effects of unconventional policy tools causes me to give more weight to their risks and eventual consequences.

In raising these issues, it is not my goal to prematurely withdraw support. It is critical, however, to ensure we transition from a crisis-type policy stance of aggressive easing to one of accommodation that allows markets, households and businesses to begin to normalize their expectations for interest rates. In my view, therefore, we should not underestimate the risk of an extended period of zero interest rates and the accompanying incentives that may lead to future financial imbalances. Such imbalances could unwind in a disruptive manner and cause the labor market recovery to stumble. I am concerned that monetary policy at its current settings is overly accommodative relative to the long and variable lags with which it operates.

Central banks must focus on achieving sustainable growth in the long run and be patient in pursuing its longer-run goals. Attempting to speed up the recovery process creates risks that, if realized, could lead the economy down a more difficult road back to full employment and price stability.