

The U.S. Economy and Monetary Policy

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

Central Exchange  
Kansas City, Missouri  
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The views expressed by the author are her own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

I'm pleased to be back at the Central Exchange. This is an important organization for women in Kansas City who contribute actively to our community in so many different ways, and it provides an important forum to share ideas, experiences and opportunities. The Kansas City Fed supports these goals, which are also reflected across all levels of our organization. Women play an important role on the Boards of Directors of our four offices and on our executive management team. In fact, several members of our leadership team are members of the Central Exchange, and I know their involvement here has benefited both them and the Kansas City Fed.

I'm also honored to begin the New Year by continuing the tradition of first sharing my 2013 outlook for the economy here at the Central Exchange. Last year when I spoke, I was relatively new to the job as president of the Kansas City Fed. Over the past year, I have participated in meetings of the Federal Open Market Committee and traveled thousands of miles around the region and globe. In doing so, I have gained insights on the state of the economy in this region, in the nation and around the world, from sawmill operations in Hulett, Wyo., to international conversations in China.

I also would note that although I have worked for the Kansas City Fed for more than 30 years, I have developed, in this broader role, a renewed appreciation for the Federal Reserve's structure, which provides 12 independent regional views on the economy in addition to the seven members of the Board of Governors in Washington. As a policymaker and Reserve Bank president, I have benefited tremendously from the insights of business leaders, financial market professionals, and others in our seven-state region who provide real-time perspectives on the economy and give me a forward-looking view of economic conditions. And those perspectives contribute importantly to my policy views at the Federal Reserve's monetary policy deliberations.

Later this month the FOMC will meet for the first time in 2013. Although each of the 19 participants at that meeting always engages fully in the discussion, only five of the 12 regional Reserve Bank presidents vote in a given year. I am a voting member this year.

Given the current state of the world, much may yet change before this next meeting. Nevertheless, today I want to share with you my outlook for the U.S. economy and its ongoing recovery from a deep recession. I will then outline my perspective on the current stance of monetary policy and the challenges ahead.

### **The pace of recovery**

We are now in the fourth year of the economic recovery. It has been a slow and uneven recovery. The unemployment rate remains a relatively high 7.8 percent, and most estimates for GDP growth going forward suggest a modest 2 percent rate.

There are several reasons why this recovery has been slower than in the past. For example, consumers have been deleveraging, perhaps wisely so. Based on analysis by staff at the Kansas City Fed, the percentage of consumers taking on more debt fell sharply during the last recession and has only modestly recovered. This reduction in debt has occurred across a wide variety of income groups and among individuals with widely varying access to credit. This reduced willingness to borrow, even at the current low interest rates, reflects recognition among households of the need to repair their balance sheets and restore their credit standing. Its effect also then is to slow consumer demand and to constrain GDP growth.

Consumers' balance sheet adjustments are not the only factor hampering the pace of the economic recovery. Corporations also have been strengthening balance sheets, hoarding cash and often times borrowing to buy back shares or build cash reserves rather than build productive

capacity. And among these corporations are our nation's largest banks, which, during most of the past four years, have focused on repairing their own balance sheets while struggling with persistent double-digit delinquency rates on home loans and trying to manage the legal and regulatory uncertainties related to mortgage lending. These factors have impeded their willingness to lend for growth. Indeed, the four largest banking companies are 30 percent larger today than they were at the start of the financial crisis, but their business lending still has not returned to its 2008 peak.

And finally, it is hard to find any news report that does not highlight the global uncertainty affecting business and consumer choices and their willingness to hire and spend. Concerns about fiscal policy here in the United States, or the sovereign debt crisis in Europe, all are playing a role in making this a difficult economic recovery.

### **Room for optimism**

If you look a little closer, however, you will also see a recovery that is building momentum despite the barriers impeding progress—and the progress is notable given the debt burden our economy carries and the depths of the financial crisis and recession we have suffered.

Our economy's production of goods and services is back to its pre-recession level. Key sectors of the economy are showing marked improvement and are strengthening as we enter 2013. In particular, the housing sector has been showing convincing signs of healing after its fall during the crisis. House prices are now about 5 percent higher than a year ago and construction activity is steadily picking up. The auto sector is also benefitting from strengthening demand. Auto sales for 2012 came in 13 percent higher than in 2011 with 14.5 million vehicles sold—the highest level in about five years. Manufacturing activity has also held up reasonably well near

the end of last year, despite concerns that the United States might go over the so-called fiscal cliff.

Part of the improvement in housing and auto sales reflects some improvement in the labor market. Employment growth averaged a bit more than 150,000 jobs per month in 2012—enough to keep up with population growth and slowly absorb some of those who are unemployed. To be sure, unemployment remains high and growth during this recovery has been only moderate despite more than four years of zero interest rates and aggressive large-scale asset purchases by the Fed.

Pulling all these factors together and sorting through the fog of uncertainty, I expect that the economy will continue to grow a bit more than 2 percent in 2013 and that the level of unemployment will continue to decline, perhaps by another half a percentage point. This of course will depend on what happens in the Congress and across the globe. The economy also will be affected both in the short run and long run by Federal Reserve policies. So, let me turn now to monetary policy.

### **Monetary Policy Challenges**

The deep recession of 2007-2009 and the slow pace of the subsequent recovery prompted forceful action by the Federal Reserve and other central bankers around the world. As the severity of the recession and the financial crisis became clear, the FOMC lowered the federal funds interest rate on overnight loans, its traditional policy instrument, to within a target range of between zero and  $\frac{1}{4}$  percent.

With short-term interest rates effectively at zero since late 2008, the Federal Reserve has turned to unconventional policy tools designed to reduce longer-term interest rates in order to

provide additional support for the economic recovery. These unconventional tools have taken the form of large-scale asset purchases and announcements regarding the FOMC's intentions for future policy actions. Taken together, the monetary policy actions of the past few years have provided the economy with an unprecedented level of accommodation and a commitment to maintain an extraordinary level of accommodation well into the future.

At its last meeting, the FOMC announced that, provided the inflation outlook does not move above 2½ percent, it expects to keep the federal funds rate close to zero until the unemployment rate reaches 6½ percent. In addition, the Committee decided to continue purchasing \$85 billion in securities each month.

Large-scale asset purchases were first introduced as an emergency measure in response to the financial crisis in 2008. The policy was continued into the following years to speed up the recovery, most recently with the announcement of open-ended purchases of both Treasury and agency mortgage-backed securities.

These purchases, as intended, add reserves to the banking system and are designed to lower longer-term interest rates, affecting investments and borrowing. The policies have been supportive for the housing and auto sectors, as consumers are more likely to borrow and purchase a home or new car when interest rates are low. To a lesser extent, accommodative monetary policy also supports housing and equity prices so households can strengthen their balance sheets.

These purchases also have their own set of risks and are not without cost. At their current level and pace of growth, I believe they almost certainly increase the risk of complicating the FOMC's exit strategy. The Fed's large holdings of both Treasury and agency MBS will eventually need to be shed from the Fed's balance sheet. Although such actions are likely only

well into the future, actively selling a large amount of agency MBS, as stated in the exit strategy principles, could be potentially disruptive to markets and market functioning, or cause an unwelcome rise in mortgage rates. Moreover, these purchases reinforce the perceptions that monetary policy will remain highly accommodative for a prolonged period, regardless of circumstances, thus risking an announcement shock when the Committee at last must reverse policy.

To be clear, I agree that the depth of the last recession warranted a highly accommodative monetary policy response. Further, a recovery marked by high unemployment and low inflation may well warrant low rates for a longer period than usual. But, while I agree with keeping rates low to support the economic recovery, I also know that keeping interest rates near zero has its own set of consequences. Specifically, a prolonged period of zero interest rates may substantially increase the risks of future financial imbalances and hamper attainment of the FOMC's 2 percent inflation goal in the future.

### **Risks to financial stability**

A long period of unusually low interest rates is changing investors' behavior and is reshaping the products and the asset mix of financial institutions. Investors of all profiles are driven to reach for yield, which can create financial distortions if risk is masked or imperfectly measured, and can encourage risks to concentrate in unexpected corners of the economy and financial system. Companies and financial institutions, such as insurance companies and pension funds, and individual savers who traditionally invest in long-term safe assets, are facing challenges earning reasonable returns, and so they may reach for yield by taking on more risk

and reallocating resources to earn higher returns. The push toward increased risk-taking is the intention of such policy, but the longer-term consequences are not well understood.

Of course, identifying financial imbalances, asset bubbles or looming crises is inherently difficult, as policymakers were painfully reminded during the financial crisis in 2008. Public transcripts of the FOMC's discussions from as early as 2006 show participants were clearly focused on issues in the housing market and yet did not fully appreciate the risk to the economy from the financial sector's exposure to risky mortgages.

Accordingly, I approach policy decisions with a healthy dose of humility when considering the long-run effects of monetary policy. We must not ignore the possibility that the low-interest rate policy may be creating incentives that lead to future financial imbalances. Prices of assets such as bonds, agricultural land, and high-yield and leveraged loans are at historically high levels. A sharp correction in asset prices could be destabilizing and cause employment to swing away from its full-employment level and inflation to decline to uncomfortably low levels. Simply stated, financial stability is an essential component in achieving our longer-run goals for employment and stable growth in the economy and warrants our most serious attention.

### **Risks to the stability of inflation expectations**

The exceptionally long period of extraordinary monetary policy accommodation could also become a threat to the stability of longer-term inflation expectations. Theoretical analyses of monetary policy suggest that committing to a prolonged period of low interest rates can reduce unemployment and raise inflation, possibly above the FOMC's 2 percent goal. The FOMC has put this idea into practice by expressing, with its adoption of thresholds for inflation and unemployment, its tolerance for having the inflation outlook exceed 2 percent.

There is, however, an important caveat to such analyses: they assume the FOMC's longer-run inflation goal is never in doubt. In reality, a willingness to let inflation rise above the 2 percent goal for a protracted period carries the risk that longer-term inflation expectations may slip above levels consistent with the Committee's 2 percent goal and calls into question the Committee's commitment to its inflation goal. Restoring such a dent in the Federal Reserve's credibility would no doubt be very costly for the economy.

In fact, history provides a valuable lesson here. With the benefit of hindsight, economists have concluded that in the early 1970s the growth in the economy's productive capacity slowed. By some accounts, the Federal Reserve's attempts to speed up the economic recovery in the face of lower growth potential ultimately contributed to a decade of high inflation. Discerning such slow-moving trends as they unfold in real time is extremely difficult, and failing to recognize them, or worse yet, ignoring them because they are so gradual, can be tremendously costly for the Federal Reserve and the economy.

### **Conclusion**

In promoting its longer-run goals, the FOMC must weigh the benefits and the risks of maintaining an unusually accommodative monetary policy stance for a protracted period. Like others, I am concerned about the high rate of unemployment, but I recognize that monetary policy, by contributing to financial imbalances and instability, can just as easily aggravate unemployment as heal it. Economic models tend to highlight the benefits of such a policy, but cannot fully account for the future risks.

I have highlighted the risk of financial instability and the risk of higher inflation because, although some say they are unlikely, history shows that becoming too sanguine about either can lull us into thinking we can avoid them.