A Steady Transition for Monetary Policy

Esther L. George
President and CEO
Federal Reserve Bank of Kansas City

2014 Agricultural Symposium
Federal Reserve Bank of Kansas City
Kansas City, Mo.
July 15, 2014

Good evening. We are delighted that you could join us for this year's Agricultural Symposium. This program seeks to understand how recent developments in agriculture might translate to new economic challenges or opportunities in the months and years ahead. Importantly, the insights you bring from your respective industries, ranging from banking and finance to the agribusiness, academic and government sectors, contribute to informed views of these issues and play an essential role in the success of this program.

This is the fifth year we have hosted this symposium, which focuses on current and emerging issues in agriculture that affect the national and regional economy. Over the past year or so, we have seen some significant developments in agricultural markets as crop prices have fallen sharply and livestock prices set new records. As I travel throughout our district, I hear questions about what the economic implications might be for a sector that is increasingly global. This year's symposium, "Structural Transitions in Global Agriculture," seeks to address such questions.

Macroeconomic trends and monetary policy are broad forces that influence any industry facing difficult decisions. In that respect, agriculture is no different. This afternoon's presentations highlighted some of the macroeconomic forces driving demand for agricultural products and services, as well as how institutions are responding to general market conditions.

Against this backdrop, I am pleased to share my views this evening on the outlook for the broader, national economy and the transitions ahead for monetary policy. I will focus in particular on the challenges associated with the transition from an extended period of ultra-low rates to a longer-run monetary policy framework. Of course, the views I am sharing with you tonight are my own.

Economic Conditions

The economy has been growing now for about five years, though the pace has been disappointing relative to past recoveries. And although many had optimistic growth projections for 2014, we have yet to see evidence of a significant bounce. The year began with an unusually harsh winter and businesses that substantially pared inventories, which shrank economic output in the first quarter. Even so, the expansion remains generally solid, and I expect the economy will continue growing at a moderate pace based on the progress we've seen in labor markets and inflation expectations that remain stable.

The labor market has made promising improvements. In 2011, the economy added about 90,000 new jobs each month. The average this year has been more than 200,000, with broad-based gains across industries. As a result, the unemployment rate has dropped to 6.1 percent, its lowest point in nearly six years, and has declined over the past year at its fastest pace in three decades. Although some of this decline reflects a lower labor force participation rate, broader measures of unemployment have also improved rapidly. For example, the unemployment rate including those working part-time for economic reasons or who consider themselves marginally attached to the labor force has fallen at its fastest rate on record.

Another positive aspect of the labor market is the number of job openings. There are currently more than 4.6 million posted job openings in the United States—about the same number at the peak of the last expansion. I continue to hear that firms are having difficulty finding qualified workers. While finding good workers is always hard, they are becoming scarcer as the labor market continues to improve.

Inflation has firmed and its current pace is running slightly above the projections from the Federal Open Market Committee (FOMC). One factor is the rise in food prices, which is cause for some concern because food comprises a large share of lower-income households' resources. Because these households spend nearly all of their income, any strain on their purchasing power from higher food prices results in weaker demand for other goods and services.

In addition to food, rents in many parts of the country are also rising more quickly. Over the past three months, rents have increased at their fastest pace since the end of the recession, despite the rapid building of new apartments. With slower demand for homeownership since the financial crisis and tighter mortgage credit conditions, the pressure on rental prices is likely to continue.

Higher food and rental prices pose particular concern in the face of modest nominal wage gains. Although some measures of wages are showing signs of moving higher, they are still barely outpacing inflation. At the end of 2012, average hourly earnings had risen about 1.5 percent year-over-year, but more recently have trended up to about 2.25 percent. As the labor market continues to strengthen, wages should begin to rise at a faster pace.

By the end of next year, I expect the economy will continue to grow and bring the unemployment rate to near its longer-run normal level with rising inflation. Accordingly, it is entirely appropriate to normalize the stance of monetary policy by bringing the current asset purchase program to an end and laying the groundwork for less accommodative and more sustainable monetary policy.

The appropriate level of short-term rates

Over the past five years, the Federal Reserve has sought to offset the slower-than-usual recovery through a variety of unconventional policies, such as asset purchases and forward guidance on short-term interest rates. In addition, short-term nominal rates have been near zero since the end of 2008—an unprecedented setting in the modern era of U.S. monetary policy. Given the nature of the economic recovery, policymakers have relied on various benchmarks to justify a policy stance of near-zero interest rates. In contrast, many of those benchmarks now suggest short-term rates should be above their current level—that is, the Fed should already be raising rates.

Some argue that the nature of the financial crisis and slow recovery warrant a more-accommodative interest rate stance than usual and is a reason to move more slowly than what these benchmarks suggest. However, getting interest rates off zero relatively soon is not only appropriate in terms of current economic conditions, but also will allow the Fed room to maneuver in the future should economic activity slow. As asset purchases come to an end, it will be important to lay the groundwork for a more-normal rate environment. Adjusting short-term interest rates in response to economic conditions is preferable to intervening in longer-term Treasury or mortgage markets. As a result, today's economy, with a strengthening labor market and rising inflation, is ready for a more-normal rate environment. Furthermore, waiting too long may allow certain risks to build that if realized, could harm economic activity without room to adjust rates in response.

Such risks, for example, come from the financial system's efforts to adapt to a near-zero interest rate environment. We have seen signs of reaching-for-yield behavior in the leveraged loan market, subprime auto lending and corporate bonds. In each individual market, perhaps, one can find a justification for the lofty asset price valuations and aggressive lending practices—nevertheless, taken together, these patches of potential excess paint a picture of financial markets that have become overly conditioned on high degrees of monetary accommodation. The low interest rate environment has also pushed some savers who have traditionally relied on safer assets into riskier securities. Questions are growing as to whether savers understand the risks associated with carrying a riskier portfolio, especially those who are retired or nearing retirement. Finally, the VIX, a measure of expected changes in the stock market that is viewed as a gauge of fear of large market movements, has lately been historically low. While a lack of fear in markets may sound positive, it is a sign that market signals may be dulled by excessively accommodative monetary policy.

Recently, a fair amount of attention to the issues of financial stability have been focused on whether monetary policy should address these imbalances with a rise in interest rates or whether regulation associated with the newly embraced macroprudential approaches can suffice. Unfortunately, I expect neither offer perfect solutions. As I have noted in previous remarks, monetary policy cannot distance itself from the incentives it has created and the effects of rates that are too low for too long, and macroprudential supervision, for all its promise, is not yet a proven cure for excess risk-taking.[1]

Weaning markets off of this unusually strong level of support will be challenging. But policy needs to confront this challenge. Otherwise, expectations of ultra-low rates will persist and may become further entrenched. Expectations of low rates often go hand-in-hand with expectations of low inflation and low growth. While low rates can benefit growth by encouraging households and firms to borrow and invest, this interest rate channel is only one aspect of monetary policy and has proven to be less effective in the face of a deleveraging economy. And by keeping rates unusually low, policymakers may signal pessimism that the economy is not strong enough to begin moving to a more-normal rate environment. Moving rates up in line with improving economic fundamentals not only helps foster price stability in the

[1] Esther George. "Current Monetary Policy and the Implication for Supervision and Regulation." Remarks delivered at the Ninth BCBS-FSI High-Level Meeting for Africa. Cape Town, South Africa. Jan. 31, 2014. Available at http://kansascityfed.org/publicat/speeches/2014-George-CapeTown-FSI-01-31.pdf.

longer run, but also sends a clear message that the Fed sees the economy as finally moving past the damage inflicted by the crisis.

A longer-run framework for monetary policy

As a result of the broader economy's improvement, last December, the Federal Reserve began slowing the pace at which it adds accommodation. The FOMC minutes from the last meeting highlight the Committee's discussion of the next steps in the normalization process, which include bringing the current asset purchase program to an end.

Once asset purchases are completed, the next step will necessarily involve raising short-term interest rates, though the mechanics of how this will be done will differ from the past. Prior to the crisis, the mechanics of monetary policy would hardly be of much interest. The Fed would steer short-term interest rates through relatively routine interventions in a narrow, overnight segment of the money market composed primarily of depository institutions.

Today, depository institutions rarely need to borrow in these overnight markets, primarily because the Fed's large-scale asset purchase programs have flooded the financial system with liquidity. And because the level of reserves will most likely remain high at the time of liftoff, the Committee may need to rely on new tools to raise rates.

Regardless of the specific methods the Fed may use to control short-term rates, two important principles should remain at the core of how the FOMC approaches monetary policy in the longer run. The first is returning to a Treasury-only portfolio. The Fed has engaged in the purchase of agency mortgage-backed securities, which specifically allocates credit to those seeking a mortgage. Such activities, in my view, are not appropriate central bank actions, particularly in non-crisis periods. The second principle is a return to a policy framework of influencing short-term rates. Even if the Fed's balance sheet remains elevated for some time, as it is likely to be, the FOMC should not use the balance sheet as a tool of monetary policy in non-crisis periods. That is, the Fed should return to its focus on controlling short-term rates and resist using balance sheet policy to steer longer-term interest rates. In my view, attempting to directly influence longer-term rates is something a central bank cannot do with any precision, and thus risks doing more harm than good.

A steady path to exit

Exiting this unconventional monetary policy stance is necessary, but it will certainly pose challenges. One possible bump could be a reemergence of volatility in financial markets. Volatility is not necessarily negative, as it often arises in markets during the price discovery process. Still, too much volatility could rattle confidence and affect financial markets in a way that is detrimental to economic growth.

Should financial market volatility increase, some may argue the FOMC should slow or even reverse any steps taken in the normalization process. While policy needs to respond to incoming data, adjusting policy to bursts in financial market volatility or in response to temporarily soft data needs to be done with caution as stop-start policy reactions have historically produced poor economic outcomes. As a result, I see the economy as best served by steadiness during the normalization process.

The approach for reducing asset purchases has been effective and serves as a good example for the next phase of policy. The pace of the taper has been modest, at least by the standards of the Fed's $4.5 trillion balance sheet, but steady. The pace of asset purchases has been cut by $10 billion per meeting since last December, all while the Committee has observed a variety of data, such as a strengthening labor market, softening in the housing market and rising inflation. Even the rather sharp decline in first quarter real GDP was not cause to deviate from the pace of reductions. This does not suggest that the pace of the taper is not data-dependent, as policy will certainly adjust should an accumulation of evidence signal a change in economic conditions. Instead, the bar for altering the pace was relatively high. I see this steady approach as having helped policy resist the temptation to react to the latest data point. As a result, the approach has allowed continued progress towards normalization.

Navigating the transition to less accommodative policy can be accomplished, but smooth sailing cannot be assured. History offers encouragement that the Fed can resolve to hold to a steady course and reach its destination in spite of rough waters and headwinds. During the period following the Great Inflation, former Fed Chairman Paul Volcker weathered tremendous adversity associated with the central bank's response to high inflation. Necessary measures taken by Chairman Volcker were resisted both inside the Fed and publicly. Today's economy and its issues may look very different, but the inevitable transition and accompanying adjustments will demand no less resolve.

Conclusion

Although the economic recovery following the crisis has been uneven, the economy has continued to grow over the past five years. The labor market appears to be moving into a higher gear. Inflation has also risen. As a result, many of the benchmarks that offer guidance on how to set interest rates suggest short-term rates should be higher than they are today. The transition to less accommodative and more sustainable policy will be challenging, though monetary policy does not want to find itself with a different set of problems that may arise by waiting too long. A steady path toward raising short-term interest rates, similar to how the Fed has approached the reduction in asset purchases, will serve the economy well.