Evaluating the Balance of Economic Risks and Monetary Policy

Remarks by

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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.

It's a pleasure to join you today for this annual Economic Summit. As a Federal Reserve policymaker, I took particular note of the theme for this year's event. Thinking about the ripple effects of monetary policy is something that occupies a great deal of my time and focus. Not only considering how those effects ripple through the economy but also how they ripple through time and the implications that those policy actions can have well into the future.

Today, I am going to be sharing with you my views on recent economic developments along with my thoughts on the outlook for the national economy and the appropriate course of monetary policy. I want to stress that these views are my own and not those of the Federal Reserve System.

The U.S. Economic Outlook

The U.S. economy's average 2 percent growth rate is quite modest by historical measures. Expansions dating back to 1961 have produced growth of some 4.1 percent on average. But what this current expansion has lacked in strength, it has made up for in longevity. April marks the 94th consecutive month of growth, making it the third-longest U.S. expansion on record going back to about 1850.

Over this recovery, the U.S. economy has witnessed a remarkable improvement in labor markets. The unemployment rate has fallen from a peak of 10 percent to 4.4 percent today. Granted, this is a broad measure, and it is true that some areas of the labor market could benefit from further improvement. Rather than picking and choosing which indicators best describe the state of the labor market, Kansas City Fed staff looked at how we could summarize 24 different labor market variables by creating two indicators: one that looks at the level of labor market activity, and the other at the momentum of that activity. The most recent results confirm continued strength. Both indicators were above their historical averages, suggesting a somewhat "tight" labor market with forward momentum pointing to continued improvement. In fact, the momentum indicator is at its highest level in the history of the series, which goes back to the early 1990s.

With labor markets showing little or no slack, why then did real Gross Domestic Product (GDP) only grow 0.7 percent in the first quarter? Importantly, does this weakness call for the Federal Reserve to pause its process of normalizing monetary policy?

For a number of reasons, I think the answer is "No."

First, some of the weakness reflects unusually mild winter weather that led consumer spending on housing and utilities to decline sharply in the first quarter. Although such an effect temporarily reduces measured output, it is clearly not cause for concern. In fact, household saving increased by over half of a percentage point between December and March, likely reflecting lower utility bills.

The second reason is a more technical one – what economists call "residual seasonality." Namely, despite the best effort of statisticians to smooth through predictable seasonality, we have seen a pattern emerge in recent years in which measured growth is weaker in the first quarter than it is during the rest of the year. I suspect we are seeing this same dynamic, at least in part, in 2017.

The third reason is that economic data is subject to dips and spikes. Despite best efforts, measuring a dynamic, $19 trillion dollar economy is an extremely difficult task. As a result, we should be careful not to overreact to every move in reported data. To illustrate some of the challenges in measuring economic activity, my staff recently issued a report on the so-called sharing economy, a business model in which customers who are looking for rides or rooms, among other goods and services, are matched with providers via online platforms.[1] While this type of activity remains too small to affect our understanding of recent macroeconomic trends, the report highlights some of the difficulties statisticians face when trying to capture emerging economic trends.

As we consider these factors affecting the nation's GDP, we are likely seeing a significant amount of noise. The core signal, I believe, may have more strength than what we are currently able to determine.

Still, interpreting the data is a balancing act. Just as one should not overreact to each single data point, it is important to watch for signals that could mark a turn in the economy. For example, one area I am watching closely is auto sales. After setting a record last year with 17.5 million light weight vehicles sold, the pace of vehicle sales slowed in the first quarter. Recently-released data for April did rebound a bit to just under 17 million on an annualized basis, but sales remain below last year's level. Some cooling raises questions about softening consumer demand. On the other hand, indicators of consumer sentiment remain high, gas prices remain low, household balance sheets are, on average, healthy and other fundamentals suggest consumers have the ability to continue spending.

All told, while the recent GDP report and auto sales may be flashing yellow, numerous other indicators remain solid green. In particular, consumer and business confidence remain strong, as do surveys of business conditions. For example, the ISM manufacturing index, which surveys manufacturing firms across the U.S. about business conditions, has been signaling a strengthening manufacturing sector over the last eight months. Its nonmanufacturing counterpart, which covers the broader services sectors, has also been solid as of late.

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[1] Redmond, Michael. 2017. "Waiting for a Pickup: GDP and the Sharing Economy," Federal Reserve Bank of Kansas City, *The Macro Bulletin*, April.

Likewise, global economic conditions have improved, supporting exports, and downside risks posed by China and Europe have diminished. Given the strength of fundamentals across a range of sectors, I expect the economy to continue growing at a slightly above-trend rate.

With this outlook, I view inflation dynamics as broadly consistent with the Federal Reserve's goal of price stability. Personal consumption expenditure (PCE) inflation was 1.8 percent over the past year after averaging just 1 percent for much of 2016, and core inflation has been trending up. Its unexpected decline in March appears to reflect some one-off factors as opposed to broader disinflationary pressure. It seems reasonable to look through this volatility, with labor markets continuing to improve, and longer-term inflation expectations staying anchored near 2 percent.

The Balance of Risks

Developing an outlook for the economy requires not only judging the health of the economy over a medium-term horizon, but also requires an assessment of the nature of risks to that forecast. Now that the U.S. has largely recovered from the Great Recession – the unemployment rate is below its estimated longer-run level, real gross domestic product (GDP) is growing slightly above its estimated trend, and inflation is near the Federal Open Market Committee's (FOMC) longer-run objective of 2 percent – I will turn to my thoughts on the balance of risks. And here I would point out an important shift in the FOMC's assessment of risks since it took its first steps to normalize monetary policy in December 2015.

At that time, inflation was moving closer to the FOMC's desired 2 percent objective, and the labor market reflected substantial improvement. However, nearly half of the FOMC participants continued to view the risks to inflation as weighted to the downside – highlighting concerns that inflation might start to move further below the objective.

A year later, with sustained improvements in the labor market and progress toward the Committee's inflation objective, the FOMC took a second step toward monetary policy normalization, raising short-term interest rates another 25 basis points. By then, the assessment of risks had changed. An overwhelming majority of participants viewed the risk to their inflation forecasts for 2017 as broadly balanced, and a few more reported that risks were weighted more to the upside than the downside.

The same is true for judgments about risk to the outlook for the unemployment rate. A large majority currently sees risks as broadly balanced, but a few participants see risks that the unemployment rate is more likely to be even lower than their projection.

The assessment that risks to the unemployment rate are balanced right now is a reasonable one, although having the unemployment rate fall below its longer-run level is not without risk. At 4.4 percent, the unemployment rate is already below the FOMC's median estimate of the longer-run unemployment rate, and overshooting poses risk to the sustainability of the expansion. Past episodes to push unemployment lower than its longer-run level have ended in recession, and for that reason, adjusting policy to ensure the economy remains on a sustainable growth trajectory is of paramount importance.

Others may argue that concerns about the economy potentially overheating are exaggerated. For example, the link between low unemployment and rising wages is weaker than it was a few decades ago. This means tighter labor markets may be unlikely to generate as much inflation as in the past. While I acknowledge that the link between real activity and inflation appears to have diminished, there could very well be conditions when the relationship reasserts itself. That is, under tight labor markets, employees may find themselves with significantly more bargaining power to negotiate for higher wages, which in turn could translate into more inflationary pressure.

Another point often raised to suggest the Federal Reserve need not be overly concerned with tight labor markets is that inflation has been running below the FOMC's 2 percent goal for an extended period. Such low rates of inflation seem to have lowered longer-run inflation expectations. Given the inflation goal is symmetric, meaning that the Committee gives equal weight to deviations above and below the goal, some argue there is scope to let inflation drift above 2 percent for a time, particularly if it would help anchor expectations more firmly around 2 percent.

I have not yet found this argument compelling. The most recent estimate from the Survey of Professional Forecasters points to future levels of inflation slightly above the FOMC's 2 percent goal. In fact, some consumer expectations of inflation have slipped, but not sufficiently to suggest they have become fundamentally unanchored from the inflation goal.

Monetary Policy

Last week, the FOMC took no action to change policy, although it remains on a path to remove accommodation in a gradual manner. Given my own economic outlook and assessment of the balance of risks, I support this policy path.

It is worth noting that even as the FOMC has increased short-term rates, financial conditions remain accommodative. Looking at the Kansas City Fed's Financial Stress Index, which synthesizes 11 financial market variables, the index has generally declined over the past six months despite two rate increases. Thus, the modest amount of removal of monetary accommodation has had little notable effect on broader financial conditions.

Looking ahead, a natural question is how gradual will the monetary policy normalization process be? According to the Fed's Survey of Economic Projections, the median calls for another 2 moves this year and financial markets appear to expect another 1 or 2 moves. The FOMC has judged that moving gradually is appropriate. Understandably, moving too aggressively risks slowing economic activity or even derailing the expansion. Removing accommodation in small doses is consistent with the economy's improving fundamentals and perceived benign rates of inflation.

Alternatively, policy cannot move too gradually. Postponing the removal of accommodation when the economy is at full employment and inflation near 2 percent poses risks to longer-run economic and financial stability. Moving too slowly carries the risk of pushing the unemployment rate below its sustainable rate and inviting recession as history shows. Failing to keep interest rates in line with improving fundamentals also can distort the allocation of capital toward less fruitful, or perhaps excessively risky, endeavors.

As monetary policy continues on a gradual path of tightening, questions emerge about the impact to those sectors of the economy that are especially interest rate sensitive. This concern is often associated with the housing sector. However, I would note that the housing market has changed significantly over the past decade. While demand fueled rising home prices prior to the financial crisis, it seems that lack of supply is now the dominant factor. For example, research by my staff suggests the number of households is at least 3.5 million below its trend, even after accounting for demographics and changes in preferences. The unmet demand for housing may face a more persistent lack of supply, due in part to limited land available for development in desirable areas. Conditions vary across regions, but with a limited supply of housing and a strong labor market, prices are likely to continue rising even as interest rates gradually go up. Even with such conditions, while higher home prices may boost measures of household wealth, those households that spend a relatively larger share of their income on shelter will face challenges.

Finally, removing policy accommodation goes beyond increasing the level of the federal funds rate. The FOMC also must begin to adjust the size and composition of its securities holdings. The Federal Reserve's balance sheet is currently about $4.5 trillion, or almost 25 percent of GDP compared to 6 percent of GDP 10 years ago. The composition of this balance sheet has changed as well. Ten years ago, the balance sheet was primarily comprised of short-term Treasuries. Today, mortgage-backed and agency securities make up about 40 percent of assets.

With these changes, the FOMC faces unprecedented challenges for its decision-making today, such as when to begin the process of reducing the size and altering the composition, and how to communicate the approach and the timing to the public. My own view is that the process should begin sometime this year by reducing reinvestments in mortgage-backed securities (MBS) and long-term Treasury securities. Once it begins, however, the runoff in the portfolio should be on autopilot and not reconsidered at each subsequent FOMC meeting. Otherwise, the Committee would need to re-evaluate and make adjustments that will potentially complicate monetary policy and provide few benefits to the real economy.

Conclusion

The economy continues to expand as sustained job growth and solid gains in household spending – the weak first quarter notwithstanding – are mutually reinforcing. The international backdrop poses less downside risks today, further supporting growth at home. In this environment, the role for monetary policy is to support the sustainability of the expansion. Therefore, as labor markets continue to tighten, continuing the gradual removal of monetary accommodation is the appropriate course for the FOMC.