

Threading the Needle

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

July 17, 2018  
Federal Reserve Bank of Kansas City Agricultural Symposium  
Kansas City, Mo.

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.

Good evening and welcome. Today's discussion has been both interesting and informative. I want to thank the presenters and discussants for participating in this year's symposium. Clearly, international trade is central to the performance of the agricultural sector, and uncertainty about trade policy clouds the outlook. I look forward to continuing the discussion tomorrow.

This evening I would like to focus my remarks on the outlook for the U.S. economy and the role of monetary policy in supporting sustainable economic growth. With the economy at or beyond most estimates of full employment and inflation near the FOMC's 2 percent objective, monetary policy should be a neutral influence on the economy. However, in my view, policy is still providing accommodation. Gradual further increases in our policy rate will be necessary to return policy to a neutral stance, although there is considerable uncertainty about exactly how far or fast we need to go. Thus, policy must thread the needle between moving too slowly toward neutral, which could lead to an undesirable increase in inflation, and moving too aggressively, which could precipitate an economic downturn.

#### Current economic conditions

Let me turn first to current economic conditions. The U.S. economy is in excellent shape, operating with tight labor markets and low and stable inflation. The unemployment rate at 4.0 percent is well below most estimates of full employment. In addition, headline inflation as measured by the Fed's preferred indicator, the personal consumption expenditure price index, recently reached 2.3 percent, while the core measure excluding food and energy came in at 2 percent—consistent with the Fed's inflation objective.

Looking back at the first half of the year, real GDP—our broadest measure of economic activity—increased at a solid pace. In fact, it accelerated from a moderate 2 percent annual rate in the first quarter to an expected growth rate of around 4 percent in the second quarter, based on various GDP tracking models. Looking ahead, we expect continued economic growth at or above estimates of the economy’s longer-run potential growth rate of around 1¾ percent.

Economic growth is broad based, and the economy appears to be firing on all cylinders. Consumer spending has supported overall economic growth since the beginning of the expansion, but more recently, we have seen a pickup in business spending on plant and equipment. In addition, we are beginning to see an increase in the pace of wage gains. For example, the employment cost index—a broad measure of labor compensation that accounts for employment shifts among occupations and industries—accelerated over the past couple of years to a 2.7 percent annual growth rate in the first quarter, after having hovered for several years around 2 percent. These wage gains along with ongoing increases in employment will continue to support increases in personal income and spending over the remainder of the year and on into next year.

With this strong performance and a legacy of low interest rates, financial stress may be building in some sectors. The corporate bond market and subprime borrowers appear to be at some risk should interest rates rise sharply. In addition, asset prices remain elevated. Nevertheless, regulators have judged the financial system to be stable, with manageable vulnerabilities. They point, for example, to the most recent assessment from the annual stress-testing of the largest banks. That said, I am concerned that regulators are not doing more to build resilient capital buffers into the banking system at a time of cyclical strength.

## The risks to the outlook

Aside from the possibility that we are misjudging the manageability of emerging financial imbalances, the risks to the outlook appear balanced. Even so, the risks—both to the upside and the downside—are significant.

The predominant upside risks in my view are a pro-cyclical U.S. fiscal policy and globally accommodative monetary policies. While estimates of the stimulative effects vary, the federal government's actions to cut taxes and increase spending have come during a business cycle expansion. These policies may have the short-run benefit of promoting spending and, perhaps, increasing the economy's longer-run growth potential by increasing business investment, but they also carry a risk of pushing the economy beyond its productive capacity. Likewise, accommodative monetary policies in the United States and other advanced economies encourage risk-taking and incentivize spending over saving. At this point in the business cycle, such fiscal and monetary policies could lead to an undesirable increase in inflation or to a further buildup of financial imbalances.

The predominant downside risks come from uncertainty around trade policy. To date, the impact of new tariffs on the broad economy has been minimal, and I have not incorporated any significant effect into my baseline outlook for the broader U.S. economy. However, anecdotal reports from our business contacts suggest that some companies are taking a “wait and see” approach to new capital spending due to uncertainty about future trade policies. Whether this will materially slow the economy over the next couple of years or threaten the sustainability of the expansion is something that I will be monitoring carefully.

## Monetary policy must thread the needle

Barring the realization of these risks to the outlook, I continue to believe the stance of monetary policy will need to be gradually adjusted toward a more neutral position. At a time of full employment with price stability, policy should be a neutral influence on economic activity. But navigating the path to neutral will be challenging.

In the first place, there is considerable uncertainty about what the neutral policy rate is and, therefore, uncertainty about how many policy moves it will take to return to neutral. Various structural changes—such as slower growth of the labor force and sluggish productivity growth—suggest the neutral policy rate is lower than in the past. But other, cyclical, factors may be partially offsetting. In addition, fiscal stimulus is likely raising the neutral rate, but it is not clear by how much.

Likewise, questions exist about the natural rate of unemployment and the slope of the Phillips curve—and whether these concepts remain relevant in today's economy. The fact that inflation has been relatively stable even as the unemployment rate has fallen well below estimates of its longer-run sustainable level suggests that either the Phillips curve is unusually flat or, perhaps, obsolete. That said, monetary policy is currently testing the limits of how low unemployment can go without causing an undesirable increase in inflation.

Monetary policy is further complicated by the extraordinary actions central banks took to promote growth during and after the global financial crisis. When unemployment was high and inflation was low relative to our targets, the Federal Open Market Committee (FOMC) greatly expanded the Fed's balance sheet and provided forward guidance to the public that policy rates would be kept low for a prolonged period. I don't dispute that some of these policies may have helped get us to where we are today. But now that the FOMC has largely achieved its objectives,

the costs of these extraordinary policy actions are becoming apparent. Even though we have begun to gradually normalize the size of the balance sheet, it remains exceptionally large by historical standards. It is still likely putting downward pressure on longer-term rates, working at odds with efforts to achieve policy neutrality. In addition, keeping rates “low for long” has resulted in a policy stance that remains accommodative in the face of tight labor markets and inflation at the FOMC’s goal.

Moreover, traditional signals of the stance of policy, such as the slope of the yield curve, have likely become distorted. A yield curve inversion—that is, a situation where short-term rates rise above longer-term rates—has historically been a strong signal that the economy might dip into recession sometime over the next six months to two years. Except for once<sup>1</sup>, such an inversion has always been followed by a recession. While the yield curve has not yet inverted, it is relatively flat by historical standards, raising the possibility that further increases in policy rates could move them above longer-term rates.

It’s not clear how concerned we should be about this possibility. As I mentioned, the Fed’s large holdings of Treasury securities may be keeping longer-term rates below where they otherwise would be and, therefore, distorting the signal from the yield curve. In addition, the level of interest rates, as well as that of the neutral policy rate, is below historical benchmarks.<sup>2</sup>

While economic conditions are quite positive right now, it is important that monetary policy be calibrated over time to sustain the expansion. The stakes are high since policymakers will have less scope to lower rates in a future downturn. Monetary policy cannot offset all of the shocks that affect the economy, and recessions will happen. But recessions can also be caused by

---

<sup>1</sup> The one time when an inverted yield curve (10-year treasury yield/3-month treasury yield) did not immediately precede a recession was in September 1998.

<sup>2</sup> Bauer, Michael, and Thomas M. Mertens, “Economic Forecasts with the Yield Curve,” *FRBSF Economic Letter*, March 5, 2018.

policy mistakes. The FOMC will need to monitor incoming data carefully to avoid moving too aggressively and causing a downturn or moving too slowly and allowing inflation to rise. Allowing inflation to rise also can result in a recession if the Fed must then raise rates aggressively to return inflation to target.

Adding to the complexity of monetary policy is that it affects the real economy with long and variable lags. Past policy actions have not yet had their full effect, and actions taken today will not have their full effect for many months into the future. This raises the risk of overshooting. Like adjusting the thermostat in a hot room to cool it down, failure to account for lags can lead one to continue tinkering with the controls. Because it takes time to reach the desired temperature, if you're not careful, it's easy to overshoot, turning a room that is too hot into one that is too cold.

All of this suggests to me that future policy actions will increasingly need to be data dependent. And given the policy lags, our actions need to be forward looking. In this context, data dependence means that policymakers should adjust their forecasts and associated policy paths as necessary based on the flow of incoming data. Therefore, I will be monitoring signs that might indicate whether we are nearing neutral or have further to go. For example, further downward movements in the unemployment rate or upward momentum in inflation would suggest to me that we have more work to do. On the other hand, stabilization of inflation and unemployment around their current levels might suggest less urgency for further policy action.

### Conclusion

Notwithstanding these challenges, the U.S. economy is currently in very good shape, unemployment is well below most estimates of its longer-run level, and inflation has moved up

to the FOMC's objective. My baseline outlook is for the expansion to continue at a moderate pace, while recognizing there are significant upside and downside risks. With a long-run view to sustain the expansion, monetary policy will need to move from an accommodative stance to a more neutral stance. Threading this needle will be challenging in the face of numerous uncertainties and the ongoing complexity of unwinding the extraordinary policy actions taken in the aftermath of the global financial crisis.