Informing Today's Monetary Policy Choices

Remarks by

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I'm pleased to welcome you to the fourth annual energy conference hosted by the Federal Reserve Banks of Kansas City and Dallas. Energy is a key sector of our regional economies. Taken together, our two regions account for more than 50 percent of U.S. oil production and an even larger share of the headquarters of U.S. exploration and production companies, including several right here in Denver.

The title and theme of this year's conference is "Energy and the Economy: Markets in Transition." As the title suggests, there are several notable transitions that we will consider and discuss today.

We will look first at the transitions underway as global oil markets calibrate the dynamics of rising U.S. production amid signs of slowing global economic growth. The Kansas City Fed's third quarter energy survey released last Friday showed that new drilling in our region has slowed further and firms anticipate more deterioration in coming months, so we are keeping a particularly watchful eye on the sector at the moment.

We will also discuss the energy transition occurring in the U.S. power utility sector driven by abundant, inexpensive natural gas and rapid growth in renewable energy generation. Within the Kansas City Federal Reserve District alone, renewables' share of electric power generation capacity has grown from less than 10 percent a decade ago to more than 25 percent in 2019. At the same time, our region produces more coal — the primary fuel being replaced in power generation — than any other Federal Reserve District. So understanding more about how this transition is evolving is vital for understanding economic trends across our region.

Finally, we will explore transitions in energy finance, with an eye toward the factors that are influencing investment and risk management within the oil and gas, and the renewable energy industries. Understanding how transitions in the broader energy sector could affect financial institutions both large and small across our region is an important aspect of the Federal Reserve's role as a bank supervisor and regulator.

To help guide us through each of these topics, we have a distinguished set of speakers and panelists with considerable expertise and experience from both the private and public sectors. I look forward to their comments and your participation in discussing these themes.

As energy markets experience transitions, they do so in the context of changing dynamics in the broader economy. My remarks today will highlight the challenges that monetary policymakers face in reading and understanding these transitions while determining the appropriate setting for policy to achieve our objectives of maximum employment and price stability.

Before I continue, however, I want to note that these are my own views and are not intended to represent the views of others in the Federal Reserve System.

THE U.S. ECONOMIC OUTLOOK

Looking across most of our economic measures, the U.S. economy is generally performing well. We are now in the 11th year of the current expansion, and the economy has, by most accounts, achieved full employment and stable prices. The unemployment rate is currently 3.5 percent, which is the lowest level on record in the past 50 years. And inflation, which historically has moved higher as the labor market strengthens, has remained low and stable.

With respect to the overall growth rate of the economy, 2019 has been a transition year. As expected, the pace of economic growth has decelerated to a level more consistent with the longer-run trend growth rate of the economy following two years of strong growth in 2017 and 2018. This transition was expected in part due to the tightness of the labor market. When an economy approaches its full-employment level, the lack of available workers, particularly skilled workers, naturally limits the pace at which business activity can expand. The latest reading from the National Federation of Independent Businesses survey confirms this dynamic. The percent of survey respondents that cited finding qualified workers as their No. 1 problem hit a 46-year record high in July.

The transition from faster growth last year to a more moderate pace in 2019 also is related to fiscal policy. The economy received a boost to aggregate demand from stimulus in 2018 in the form of a tax cut to businesses and households in addition to increased government spending. This stimulus produced a transitory boost to growth that was expected to eventually fade in 2019 and 2020.

Under these conditions, we have seen the pace of growth decelerate from a strong annual rate near 3 percent toward a pace of growth closer to 2 percent. Looking forward, I expect growth to slow a bit further over the medium term as it approaches the economy's longer-run growth rate, which I view as just under 2 percent.

While the aggregate economic growth picture has unfolded largely as expected in 2019, there are important developments in play across broad sectors of the economy. A clear dichotomy is emerging between the services sector[1], which is supported by strong consumption growth, and the goods-producing sector, which is facing a range of economic crosscurrents. Across both of these sectors, the primary driver for economic growth in the U.S. is the consumer. The strong labor market with high levels of employment and upward pressure on wages has provided the fuel to support solid consumption growth and contribute to a high level of consumer confidence. Strong consumer momentum, which is also supported by an overall personal savings

[1] Service-providing industries tied closely to the consumer include education and health services, leisure and hospitality, information, finance, and wholesale and retail trade.

rate that remains at a stable and relatively high level, has been the key underpinning of my outlook for continued economic expansion over the medium term.

The goods-producing sector, which includes manufacturing, mining, energy production and construction, has, on the other hand, faced a range of challenges that has limited its pace of expansion. For example, an expansion of U.S. tariffs on imports, retaliatory tariffs on our exports abroad, along with weaker global growth and continued uncertainty surrounding trade policy have created stiff headwinds for manufacturers. Our manufacturing survey for the region shows that activity has contracted in each of the past three months, and the national ISM survey indicates that manufacturing activity for the nation also moved into contractionary territory in August. For the energy sector, oil prices are down about 20 percent from a year ago, contributing to a slowing in drilling activity across most oil-producing regions in the country. And in the housing sector, although forward-looking indicators have improved recently, rising mortgage rates in 2018 and the first half of 2019 coupled with rising housing prices contributed to a decline in home sales and six consecutive quarters of declining residential investment.

So on balance, while the broad economy continues to grow with high levels of employment and low inflation, downside risks are prominent and have strained key parts of the goods-producing sector. This dichotomy presents a challenge for policymakers as they determine the appropriate stance for monetary policy under such conditions.

DATA DEPENDENCE VERSUS RISK MANAGEMENT

As policymakers confront this challenge, policy choices can become more difficult. Easing policy may be viewed as a proactive step to ward off weakness in a particular sector in the attempt to prevent that weakness from spreading to broader parts of the economy. Another approach would be to closely monitor the sectoral weakness, but wait until signs emerge of a broader slowdown in activity before taking action. To better illustrate this challenge, I'll talk about these different approaches to policy setting using two frequently cited descriptions: a data-dependent approach and a risk-management approach. I'll argue that both elements are important to monetary policy decisions.

Federal Reserve policymakers began using the phrase "data dependent" in 2012 to describe their approach to policy making. The phrase was intended to convey that policymakers could not credibly commit to specific actions at specific dates in the future, but instead, their view of the appropriate setting of interest rates would evolve based on new data received. Such an approach could be misread as suggesting a "data-dependent" policymaker is solely influenced by the most recent data release, basing his or her decision on the arrival of new data rather than a modal outlook for the economy.

"Data-dependent" policy decisions in my view actually encompass a much broader and multi-faceted process in which the data represent just one element. The foundation for the decision-making process is a collection of information that includes not only incoming data, but also the perspectives from my District contacts. Their anecdotes provide timely information that is not likely to appear in the data for several weeks or months given the inherent delays in reporting and revision of data statistics.

With this information in hand, judgments are required to determine how this broad information updates the economic outlook for the near and medium term. Given the long and variable lags in the time it takes for monetary policy decisions to transmit to the broader economy, one's outlook for key variables such as real GDP growth, the unemployment rate, and inflation are central to determining the appropriate policy action for today. So when I refer to a "data-dependent" approach for policymaking, it is this broader approach that I have in mind rather than a short-term reaction to the most recent data point.

A second commonly cited approach to policymaking is "risk management." This approach is not necessarily distinct from a "data-dependent" approach. Rather than focusing on one's view of the data and the mostly likely, or modal, view for the outlook, a risk-management approach seeks to assess the range of risks and then determine the policy action that best positions the economy to weather those risks.

In the current context, while one's modal outlook for the economy may be consistent with the FOMC's dual mandate, downside risks may represent alternative scenarios with undesirable outcomes for economic growth and stability. One such current risk is associated with the ongoing trade policy uncertainty. Key questions relevant for policymakers as they assess this risk would include: How have developments in trade policy impacted the economy since the start of 2018? How will trade policy decisions going forward influence the outlook? What role is trade policy uncertainty having on the decisions of businesses and consumers? Is monetary policy an effective tool to mitigate risks that may emanate from trade policy uncertainty?

Assessment of the range of risks facing the economy, which expand far beyond trade policy uncertainty, along with judgments of the possible economic implications should any of those risks transpire, may justify policy action as insurance. In such a circumstance, it may be the case that the overall economy is growing at an above-trend rate and the modal outlook is in line with our dual mandate objectives. But the emergence of downside risks could be viewed as sufficiently threatening to warrant an adjustment in policy while those risks persist.

A recent example of this type of situation occurred in 2014 and 2015 when the economy faced several shocks that impacted a few industries at a time while the overall economy was expanding at a solid pace. During this period, the price of oil fell by more than 50 percent, the dollar appreciated by approximately 20 percent, and agricultural commodity prices such as corn and soybeans fell by more than 25 percent. These shifts in prices contributed to a downturn in the energy, agricultural, and manufacturing sectors and represented downside risks for the broader economy.

In this instance, the FOMC did not choose to directly provide additional accommodation to the economy, but instead communicated a shift in its view of the appropriate path for policy going forward. Using the median of the FOMC's Summary of Economic Projections (SEP) as a reference point, the projection for the appropriate setting of policy at the end of 2016 was lowered by nearly a full percentage point from the March 2014 projection to the December 2015 projection. This adjustment provided appropriate support for the broader economy at a time when some sectors were experiencing weakness. And as the impact of those shocks dissipated over time, the FOMC then implemented the projected policy adjustments that had been delayed. During this period, the broader economy continued to expand with real GDP growth remaining above trend and average employment growth in excess of 200,000 new jobs per month.

One challenge with this type of risk-management approach to policy setting is that while the benefits of taking out insurance may be clear, the costs are not. One potential cost is that such an insurance policy risks overheating the sectors of the economy that are already performing well. This can lead to a misallocation of resources toward those interest rate-sensitive sectors at the expense of sectors that may be better positioned for growth over the longer run. A second potential cost stems from the fact that an easing in monetary policy is designed to encourage risk-taking and leverage. In the earlier periods of an economic expansion, risks associated with increasing leverage may be moderate, and as such the cost of extra insurance may be low. But these costs move higher as the economic expansion matures and as levels of corporate debt and other vulnerabilities become elevated.

MONETARY POLICY

Turning to the current monetary policy settings, data dependence and risk management continue to provide important strategy foundations for policymakers. In 2018, as the economic expansion continued and the unemployment rate moved below most estimates of its long-run level, the FOMC continued to gradually remove accommodation and the federal funds rate moved closer to estimates of its longer-run level. At the start of 2019 with an outlook for economic growth to decelerate toward its longer-run trend growth rate, downside risks had emerged and the Committee announced that it would be patient as it determined what future adjustments would be appropriate. Then at its July and September meetings, the Committee twice lowered the federal funds rates, citing implications of global developments for the economic outlook as well as muted inflation pressures.

I dissented from the recent decisions to ease policy based on my view of the outlook as it relates to the Committee's objectives for price stability and maximum employment. From a data-dependence perspective, the moderation of economic growth in 2019 has been for the most part in line with my outlook, in which I expect growth to gradually decline toward its longer-run trend level over the medium term. The combination of record-low unemployment, moderate growth, and low and stable inflation with an unchanged outlook led me to conclude that an unchanged setting for the federal funds target range remained appropriate.

Supporting an unchanged policy rate in recent meetings does not ignore the downside risks facing our economy. The emergence of those key risks to the outlook as early as the fourth quarter of 2018 caused me to moderate my expectation that further rate increases were needed. Similar to the experience from the 2014-15 period that I described earlier, I shifted downward my view of the appropriate path for policy over the next one to two years in light of the downside risks that have emerged over the past year and the implications of those risks for certain sectors of the economy. I view this as an appropriate adjustment that is consistent with both data-dependent and risk-management strategies.

While some may view the cost of a reduction in rates as benign given that inflation remains somewhat below our 2 percent longer-run target, I am mindful that rate reductions are intended to boost demand and encourage risk-taking and leverage. The ability of the Federal Reserve to offset any unintended effects related to financial stability at this stage of the business cycle seems limited. In the most recent Financial Stability Report issued by the Federal Reserve Board in May, assessments for overall vulnerabilities were mostly sanguine. But the report also noted that "elevated business debt, easy lending standards, and strong risk appetite pose a vulnerability… that potentially increases the downside risk to broader economic activity." As corporate debt continues to rise to high levels with the fastest growth among the riskiest firms, the largest banks also are lowering their loss-absorbing capital levels. I view this combination of risks as potentially costly to employment and growth, especially at this stage of the expansion.

Looking forward, I will remain attentive to the incoming data for signs that downside risks to the outlook materialize in a way that meaningfully affects broad economic conditions. Under those circumstances, I would be prepared to adjust monetary policy accordingly.

CONCLUSION

Consumers continue to drive momentum for economic expansion in the face of downside risks that over the past year have slowed activity in several key sectors. In these circumstances, both data-dependent and risk-management strategies guide policymakers as they consider monetary policy settings. My own outlook for the economy does not call for a monetary policy response. While weakness in manufacturing and business investment is evident, it is not clear that monetary policy is the appropriate tool to offset the risks faced by businesses in those sectors when weighted against the costs that could be associated with such action. Should downside risks spill over into the broader economy in a way that fundamentally affects the consumer and shifts the overall outlook, a monetary policy response may be required.