

2020 Vision: Solid Growth in a Challenging Low-Interest-Rate World

Remarks by

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

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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.

Thank you and welcome to the Federal Reserve Bank of Kansas City. I'm pleased to continue this New Year's tradition with the Central Exchange of offering my view of the economic outlook for the coming year.¹

Before I do that, however, I want to take a few minutes to remember former Federal Reserve Chairman Paul Volcker, who passed away last month. Certainly, others worked more closely with Chairman Volcker than I did, and a number of wonderful tributes have been offered since his passing. But in starting a new year and reflecting on the challenges facing the Federal Reserve in 2020 and beyond, I was thinking about how much the nation and our institution in particular owes to him. His leadership and public service also have been important to me personally.

I came to work for the Kansas City Fed in 1982. I was excited about my new job as a bank examiner and pleased with my \$10,000 annual salary to help me pay for what at that time was considered an affordable 12 percent fixed-rate mortgage. Paul Volcker was the Fed Chair who signed my examiner credentials. In that role, I would learn that he paid close attention to the health of the financial system, including small banks in this region. He understood well that high interest rates were taking their toll on the economy and especially in our region where agriculture, energy and real estate conditions resulted in hundreds of bank failures. He also understood that the long-run health of the economy and the public's well-being depended on breaking the back of high inflation. That took courage to endure short-term—but very real—suffering for long-term benefits.

After I became president of the Kansas City Fed in 2011, Paul Volcker took my calls and always welcomed a visit to New York, willing to share his experience and advice with a new Fed

¹ I thank Kansas City Fed Vice President and Economist George Kahn and Senior Vice President Diane Raley for their assistance in preparing these remarks.

president like me. He was a source of encouragement and inspiration. And even in New York City, where they are proud of their “no-eye-contact-anonymity,” when you crossed the street with Paul Volcker to go to his favorite restaurant, heads turned.

He spoke his mind and his views were well informed. Watch his blunt statements at congressional hearings and other public events. Intellectual honesty, public service, and leadership were his hallmarks. And even if you didn’t agree with him, you knew where he stood and that his interest was in how best to serve the American public.

Finally, the Kansas City Fed owes a debt of gratitude to Paul Volcker whose attendance was essential to the 1982 launch of our fledging economic policy symposium in Jackson Hole, Wyoming. In the years that followed, he remained accessible to us. In 2009, Paul came to Kansas City, where he was awarded the Truman Medal for Economic Policy. He was willing to read our Bank’s proposals and papers and would offer his comments – sometimes criticism, sometimes support – but it was always helpful and welcomed insight.

Certainly, I did not agree with him on every issue, but that is never the point. Leadership, integrity, and service were at the core of his character, and it’s something to aspire to today. It was an honor to have started my career under his leadership as Fed chair and to have engaged with him during his post-Fed years. I am grateful for his mentorship.

Of course, the economic environment that we face today is quite different than the one that challenged Paul Volcker and his colleagues on the Federal Open Market Committee. That is perhaps a good segue to sharing my views on the challenges the Federal Reserve faces in 2020 as we consider the economic landscape and our monetary policy settings.

When I spoke to you last January, the economy looked to be in good shape in terms of growth with low unemployment and low inflation. At that time, the Federal Reserve had raised

its policy interest rate to a range of 2¼ to 2½ percent—a total of 225 basis points since the end of 2015. The lengthy expansion seemed poised to continue with historically low unemployment and muted inflation, although sentiment began to sour and recession fears mounted in the face of slowing global growth and trade policy uncertainty. Given these downside risks, the Federal Reserve reversed course last July and eased policy three times.

Outlook for 2020

As we turn the page to a new year, many of the themes from 2019 seem likely to carry over to 2020. In particular, I continue to see the expansion supported by solid growth in consumer spending with continued weakness in manufacturing and business spending. While a strong labor market and rising incomes will support consumer spending, the underlying cause of weak business spending—sluggish global growth and ongoing trade tensions—will likely persist over the near term. The combination of these factors should lead to slower growth in real GDP—our broadest indicator of economic activity—to its longer-run trend of 1¾ to 2 percent. With growth near trend, I would expect the unemployment rate to remain near its current level of 3.5 percent and inflation to remain benign.

Because the consumer is critical to the ongoing expansion, monitoring a number of fundamental factors that drive consumer spending will be important this year. The good news is that the consumer is entering the new year with considerable spending momentum. For example, household consumption data was stronger than expected in the third quarter with spending on durable and non-durable goods rising at a solid pace. While we don't yet have official data on

consumer spending for December, a report from MasterCard indicates a strong holiday shopping season with record high e-commerce sales.²

One reason to be optimistic that this momentum is sustainable is that residential investment appears to have responded to lower mortgage rates. Recent data indicate positive contributions from most major housing indicators, as single-family construction and brokers' commissions rebound. Forward-looking measures, such as single-family starts and permits, continue to move up strongly, suggesting the strength in residential investment growth will likely contribute to growth in the medium term.

Another key factor to keep an eye on is the labor market. With the unemployment rate at 3.5 percent, a robust labor market supported consumer spending in 2019 and should continue to do so in 2020, even as payroll growth continues to slow in line with the economy's potential. The economy added on average 176,000 jobs per month through December of last year, compared to 223,000 per month in 2018. In addition, the Bureau of Labor Statistics has reported that the pace of job openings has slowed.³

While I project consumer spending to remain robust, some moderation from recent strong growth is to be expected for a number of reasons. First, as I just discussed, employment is likely to grow at a slower pace this year than last year. Second, while the consumption of goods has remained robust, the consumption of services, which represents a larger share of consumer spending, decelerated in the third quarter. Third, real retail sales data have leveled off since reaching a peak in August of last year, and imports of consumer goods and autos have slowed.

² <https://newsroom.mastercard.com/press-releases/mastercard-spendingpulse-u-s-retail-sales-grew-3-4-percent-this-holiday-season/>

³ According to the Bureau of Labor Statistics' Job Openings and Labor Turnover Survey (JOLTS), job openings declined from 5.2% of total private nonfarm payroll employment plus job openings at the end of November 2018 (the current cyclical high) to 4.8% of total private employment plus job openings at the end of October 2019.

The recent slowing in imports may reflect the effect of tariff increases that were imposed in September and have fallen mostly on consumer goods. Finally, consumer spending could moderate based on sentiment about the economic outlook. While confidence measures remain near post-recession highs, expectations for the future bear watching. Based on the Conference Board's survey of consumer confidence, the differential between consumer expectations for the future and their assessment of current conditions has widened over the past several years. In the past, when confidence in future conditions has fallen relative to confidence in the present situation, consumer spending has tended to slow. That will be something to keep on an eye on this year.

In contrast to consumer spending, business spending has been relatively weak for some time. The goods-producing sector, in particular, which includes manufacturing, mining, energy production and construction, has faced a range of challenges that has limited the pace of its expansion. For example, 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 Kansas City Fed's region shows that activity has contracted in each of the past six months. In addition, the Institute for Supply Management's manufacturing survey indicates that national manufacturing activity moved into contractionary territory in August. For the energy sector, oil prices declined 24 percent from October 2018 to October 2019, contributing to a slowing in drilling activity across most oil-producing regions. More recently, oil prices have rebounded somewhat, which may lead to some increase in production going forward.

So on balance, the broad economy continues to grow with high levels of employment and low inflation, while downside risks have lingered and strained key parts of the goods-producing

sector. This dichotomy presents a challenge for policymakers as we determine the appropriate stance for monetary policy under such conditions.

Challenges for Monetary Policy

Looking back at last year, I viewed monetary policy decisions in light of an economy that was slowing, as expected, toward its trend rate of growth due in large part to the ebbing of fiscal stimulus and the shift to higher interest rates. But I also recognized that slower global growth abroad and trade policy uncertainty posed downside risks to the outlook. Even so, I did not support the three outright cuts in the target federal funds rate starting in July because I preferred to wait for clearer evidence that the headwinds from global developments were threatening to derail the ongoing economic expansion. I supported the decision in December to hold rates steady as a prudent move while we assess a number of factors going into this year.

With an economy growing at or above potential, a strong labor market, and low and stable inflation, policymakers will need time to judge the proper stance of policy. We will need to assess whether the 2019 rate cuts prove to be “insurance cuts” that will need to be reversed if headwinds fade. On the other hand, the 2019 rate cuts may turn out to be a reset to a more neutral policy stance, recognizing that the equilibrium federal funds rate may be lower than previously assumed. Finally, it could be the case that downside risks and uncertainties persist in a way that keeps investment spending weak and spills over to the consumer, altering the modal outlook and requiring further policy easing.

Over the longer run, a key concern is the capacity of monetary policy to address a future economic downturn should it arise. One reason for this concern is that the federal funds rate is historically low, leaving little policy space to deal with a future recession. In a typical recession,

the Federal Open Market Committee (FOMC) has reduced the federal funds rate target by 5 to 6 percentage points. With the funds rate target currently at 1½ to 1¾ percent, the Fed has less than half the policy space available relative to the past before hitting the zero lower bound on rates.

This is not just a concern for U.S. policymakers. Interest rates are at historically low levels in a number of advanced economies, including the euro area, Japan, Canada, and the UK. In fact, the European Central Bank and the Bank of Japan, as well as a number of other central banks, have set their policy rates below zero.

Central banks also have expressed concern that inflation has run persistently below their targets. In the United States, both headline and core inflation as measured by the personal consumption expenditure price index have remained muted since the Fed announced its 2 percent inflation objective in 2012. The fact that this, too, is a global issue affecting both Japan and the euro area, raises the possibility that global structural factors outside the control of policymakers are driving inflation dynamics.

In the United States, persistently low inflation has been unusual in light of historically tight labor markets. This has led policymakers to mark down their estimates of the natural rate of unemployment—the unemployment rate consistent with stable inflation. These estimates of the natural rate have come down from over 5 percent in 2013 to a median of 4.1 percent in December 2019.⁴ Even with this lowering of estimates of the natural rate of unemployment, the actual unemployment rate still remains below the natural rate. In the past, this situation would have typically put upward pressure on inflation. So it raises questions about the accuracy of estimates of the natural rate as well as about the relationship between inflation and slack in labor markets.

⁴ Based on the central tendency of the FOMC's Summary of Economic Projections (SEP) for the longer-run unemployment rate reported in 2013 and the median projection of the SEP reported in December 2019.

This weakening of the relationship between inflation and labor market slack perplexes central banks, making it very difficult to credibly achieve their inflation targets by pushing the unemployment rate down. Even if such a policy were successful it might entail a further, significant tightening of the labor market, leading to a misallocation of labor resources and a buildup of financial imbalances.

Given these concerns, the Federal Reserve is engaging in a review of its monetary policy strategy, tools, and communications. The review has several parts, including a series of Fed Listens events around the country designed to help policymakers better understand the perspectives of people from diverse backgrounds and with varied interests. The Kansas City Fed hosted one such event in October. The Federal Open Market Committee also is devoting time at a series of its regular meetings to assess lessons learned in the aftermath of the Great Recession and to consider how monetary policy can best serve the public, including possible enhancements or changes to its monetary policy framework that would help the Federal Reserve meet its statutory objectives for employment and price stability—especially in the event of a future downturn in economic activity. Fed Chair Jay Powell has indicated that the FOMC will publicly report the conclusions of its discussions, likely during the first half of this year.

Conclusion

The U.S. economy is currently doing well, with real GDP growth near trend, unemployment near record lows, and inflation low and stable. While business spending is in a soft spot, household spending has remained robust. Keeping rates on hold for now is appropriate in my view as we assess the economy's response to last year's rate cuts and monitor incoming data.

For the longer run, the Federal Reserve will be reevaluating its monetary policy strategies, tools, and communications to address future downturns in a low interest rate economy. With limited policy space between our current federal funds rate target and the zero lower bound on nominal interest rates, policymakers are likely to find themselves looking deep into the policy toolkit to fight future recessionary shocks. Clearly explaining the Federal Reserve's monetary policy strategies and longer-run goals will be essential to the institution's credibility and to the public's trust and confidence.