President's
message

The U.S. outlook and monetary policy

Since the end of the financial crisis, the U.S. economy has grown annually by about 2 percent and labor markets have made large strides toward healing. As a longer-term comparison, we are now in the fifth-longest expansion in recorded U.S. history. Inflation has also remained low and stable. While there are always uncertainties about how the economy will perform in the future, it's worth reflecting on the past and acknowledging the progress that has been made.

Economic growth slowed a bit toward the end of last year, though overall growth in 2015 was not too different than the past few years. Some of the softness reflected fewer exports and a modest step-down in the level of business investment in new structures and equipment. Other factors, like inventory adjustments, also lowered the growth estimate.

While a single quarter of slower growth is important to watch, I take reassurance that the economy remains on track due to strong job gains. In fact, job gains actually picked up toward the end of last year. Looking at longer trends, employment growth has been quite strong over the past few years. More jobs were added in both 2014 and 2015 than in any year since the late 1990s.

At the same time, demographic changes are affecting the labor market outlook. For example, U.S. population growth is slowing, which indicates not as many jobs need to be created as in the past to absorb new entrants into the labor force. As a result, I expect to see employment growth slow from this pace and would not interpret a modest slowdown as a sign of trouble in the economy.

Overall, I see job gains as underpinning stronger consumer demand for goods and services. Low gasoline prices and signs of faster wage growth should also add to consumers' ability to increase spending. And although financial markets have been volatile, household wealth remains at a high level, and house prices have been rising over the past four years. Certainly, the gains in jobs, wages and wealth have not been equally shared across households during the recovery, but overall, the general health of households' financial situations is much improved since the financial crisis.

Even as households and consumers are doing better, some sectors of the economy are facing headwinds. I mentioned earlier low gasoline prices, which of course reflect low oil prices. Because the energy sector is such an important part of the Kansas City Fed's regional economy, we monitor these developments closely. We know lower oil prices benefit consumers, but also weigh on oil producers. We have certainly seen energy-intensive states affected. For example, we are seeing more people every week filing claims for unemployment insurance in Oklahoma than was the case a few years ago.

Just as developments in the energy sector bear watching, so do challenges facing the manufacturing sector. The rise in the foreign exchange value of the U.S. dollar, for example, has resulted in lower orders from abroad for many of our exporters. In addition, foreign growth in some parts of the world has been uneven and slowing, which has affected foreign demand for some U.S. goods. Despite these headwinds, the U.S. economy has proven itself to be resilient to a wide range of shocks in recent years, including sluggish growth abroad.

Finally, inflation has remained muted as a result of lower oil prices and the strong U.S. dollar. Recent movements in each of these have been quite large by historical standards. Yet, despite these headwinds, core measures of inflation have recently risen on a year-over-year basis. And although inflation rates over the past few years have hovered below the Fed's goal of 2 percent, they have been positive and broadly consistent with price stability.

Risks to the outlook

Outlooks are subject to change, and forecasts are imperfect predictions of the future. As a result, those, like me, who rely on forecasts, must think about what could go wrong and how incoming data might affect the outlook for the economy. Gauging whether a temporary slowdown in growth, financial market volatility or foreign developments is a harbinger of weaker growth or a reflection of temporary factors can be difficult and often requires assessing broader trends and risks.

A few developments bear watching. I mentioned the energy sector. We are certainly paying attention to any spillovers that energy job losses may have on the broader economy. Elevated inventories in some sectors also pose a risk to the extent that manufacturing production slows further to better align current inventory levels with final sales and shipments of goods. Finally, global growth is commonly pointed to as a risk. While I wouldn't discount recent developments abroad, I also note that many forecasts point to a modestly stronger foreign outlook this year than in 2015. Still, some emerging markets carry substantial debt, so a crisis in one area can transmit to others. But despite these concerns, the fundamentals of the U.S. economy currently appear strong enough to sustain positive growth going forward.

The path for monetary policy

Turning to monetary policy, for seven years, the FOMC maintained near-zero interest rates and undertook a series of large-scale asset purchase programs—a policy stance responding to a historic financial and economic emergency in 2008. Accordingly, the FOMC's decision to alter that policy stance in December garnered a great deal of attention when the benchmark interest rate was increased by 25 basis points. I supported this decision, although I viewed it as a late start to what is likely to be a gradual path toward normalizing interest rates.

After such a prolonged period of low rates, the FOMC is understandably cautious. Moving rates gradually may avoid unnecessarily jolting the economy or causing excessive financial market volatility. Even looking at developments so far this year, financial markets have been quite volatile. While taking a signal from such volatility is warranted, monetary policy cannot respond to every blip in financial markets. Instead, a focus on economic fundamentals, such as labor markets and inflation, can help guard against monetary policy over- or under-reacting to swings in financial conditions. To a great extent, a bout of volatility is not all that unexpected, nor necessarily worrisome, given that the Fed's low interest rate and bond-buying policies focused on boosting asset prices as a means of stimulating the real economy. As asset prices adjust to the shift in monetary policy, it is to be expected that the pricing of risk will realign to this different rate environment.

Overall, it is important to remember that even after the first rate hike, monetary policy remains highly accommodative. Real interest rates continue to be negative and the Federal Reserve's large portfolio of Treasury and mortgage-backed securities keeps downward pressure on longer-term rates.

In communicating its intentions for

further rate increases, the Committee has noted that it expects economic conditions will warrant only gradual increases in the fed funds rate, although adjustments ultimately depend on the incoming data. My own view is that a pickup in economic growth, steady job gains and modestly higher core rates of inflation will warrant further increases.

The exact timing of each move, however, is subject to the economic environment. Because monetary policy affects the economy with lags, decisions must necessarily rely on forecasts and their associated risks—not waiting until desired objectives are realized.

If we wait for the data to provide complete confirmation before making a policy decision, we may well have waited too long. Likewise, policy may be faced with altering its trajectory if the economy's progress points to a different outlook. But in the absence of any substantial shift in the outlook, my view is that the Committee should continue the gradual adjustment of moving rates higher to keep them aligned with economic activity and inflation. These actions are often difficult, but also necessary to keep growth in line with the economy's long-run potential and to foster price stability.

Institutional challenges

As the Federal Reserve contemplates the appropriate path of normalizing its monetary policy, it naturally does so with considerable public attention. One source of this attention comes from Congress itself. Calls for legislative reforms of the Federal Reserve have persisted over the past five years, ranging from its structure and governance to its monetary policy approach and decision making. Additionally, Congress has shown its willingness to tap the Federal Reserve to fund fiscal activities ranging from new government agencies to highway construction.

I understand that Fed actions during the crisis have raised a number of questions about the institution and its scope. When Congress established the Federal Reserve more than a century ago, it designed the institution to be apolitical but with accountability to Congress. This construct was designed to protect the stewards of the nation's money supply from the vulnerabilities associated with short-term political agendas. It includes important checks and balances that are often misunderstood, but nonetheless critical to the functioning of the institution.

During my 33 years at the Federal Reserve Bank of Kansas City, the primary focus of thousands of dedicated Federal Reserve employees has been the health of the economy, supported by an efficient and accessible banking and payments system. To the extent that there is any doubt in the minds of Congress or the public about this, it is incumbent on the Federal Reserve to work with Congress in a direct and transparent way until we satisfy any remaining questions about the execution of our mission. Such dialogue would provide the highest probability for outcomes that best serve the public interest.

In that spirit, I look forward to 2016 and the promise it holds.

ESTHER L. GEORGE, PRESIDENT
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The above message was adapted from a speech President George delivered Feb. 2, 2016, at the Central Exchange in Kansas City, Mo.