“Are We There Yet?”
The U.S. Economy and Monetary Policy

Remarks by

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I'm delighted to be back with the Central Exchange for what has become something of a New Year's tradition. This year marks another rotation for me into the role of a voting member on the Federal Reserve's Open Market Committee (FOMC)—the body that sets our nation's monetary policy.

As you may know, the FOMC consists of the governors of the Federal Reserve Board, who are nominated by the president and confirmed by the Senate, and the presidents of the 12 regional Federal Reserve Banks, who are appointed by their respective Boards of Directors subject to the approval of the Board of Governors in Washington. Each of the governors and the regional Fed presidents participate in all FOMC meetings. However, voting rights are rotated among the presidents each year. In contrast to the governors and the New York Fed president, who each have a permanent vote on the FOMC, the other 11 Fed presidents share four votes on a rotating basis. This system was designed to ensure that the publicly appointed governors have a majority of votes on the Committee unless there are vacancies on the Board of Governors. As president of the Kansas City Fed, I rotate voting with the presidents of the Minneapolis and San Francisco Feds.

With that in mind, my remarks today will focus on the current state of the economy and, in that context, how I'm thinking about the stance of monetary policy.

The U.S. economy is currently enjoying one of its longest expansions, while the Federal Reserve has been gradually removing a portion of the massive accommodation it provided beginning in 2008. Short-term interest rates have moved up and the Fed's sizeable balance sheet, which reached $4.5 trillion in late 2014, has been slowly shrinking. With these conditions in play, the questions currently being asked are, "Where are we in the normalization process? Do we have some distance to go to reach a 'normal' interest rate or are we nearly there?"

These questions remind me of road trips with my children. Filled with anticipation to reach the destination, they would ask, repeatedly, “Are we there yet, how much longer?” The answer was usually a vague response, like “We’re getting close. Just look out the window.”

Today, even with GPS-like technology to serve as a guide, I find our policy map is incomplete and, therefore, I cannot give an exact answer to how close we are to a neutral setting for interest rates. There remains a host of factors that can influence its “location,” and, as a consequence, will affect the journey ahead. The truth is that a vague “we’re getting close” may be the best response I have to offer.

Let me share my thoughts on where we are and why this is the case, reminding you that the views I express today are my own.

A Look at the U.S. Economy and Where We Are

By most measures, the U.S. economy is performing well. The unemployment rate is near a 50-year low, and inflation is stable and well-anchored near the Federal Reserve’s 2 percent target. In addition, real gross domestic product (GDP)—our broadest measure of economic activity—is increasing at a moderate pace, supported by both consumer spending and business fixed investment. Last year, with accommodative fiscal and monetary policies, real GDP grew at an estimated annual rate of roughly 3 percent—somewhat above the economy’s longer-run growth potential, which is estimated to be a bit below 2 percent.

Looking ahead, I would expect to see a somewhat slower rate of growth, closer to but perhaps still a bit above, the economy’s longer-run growth potential. While we have begun to see some slowing in interest-sensitive sectors such as housing and motor vehicles, considerable underlying momentum remains and should serve to sustain the expansion. For example, business and consumer confidence are both near post-recession highs. Wages are rising at a roughly 3 percent annual rate, up from 2½ percent a year ago. Manufacturing activity has recovered from a slowdown in 2015-16 and is now expanding at a solid pace. And, employment continues to grow at a rate that is faster than required to absorb new entrants into the job market.

Alongside these favorable outcomes, there are of course factors that will affect this performance and pose risks to the outlook. On the upside, growth above the economy's longer-run potential could further stretch labor markets, leading to wage gains that are out of line with productivity growth. As these wage gains begin to shrink profit margins, firms may pass higher labor costs on to their customers causing inflation to rise. According to standard economic theory, there is a level of unemployment—called the natural rate of unemployment—at which inflation neither rises nor falls. When the unemployment rate falls below the natural rate, inflation tends to rise. There is a lot of uncertainty about where the natural rate is, but current estimates place it around 4½ percent. Thus, with the unemployment rate at 3.9 percent in December and expected to fall further, it is possible that we could be on the cusp of an undesirable increase in inflation.

On the downside, financial market conditions have tightened and become more volatile. The foreign exchange value of the dollar has appreciated, contributing to a loss of competitiveness of our exports and potentially a softening of inflation below our 2 percent objective. Credit spreads have widened, making capital investment costlier. Uncertainty about trade policy and global economic growth has increased, possibly causing businesses to postpone or rethink capital spending projects. In my travels around the seven states of the Tenth Federal Reserve District, I increasingly hear that input costs are rising, qualified workers are hard to find and retain, pricing power is limited, and that firms are pulling back rather than passing higher costs on to their customers.

Two sectors of particular importance to our region have their own unique set of challenges. The farm sector is in a prolonged downturn as a result of declining agricultural prices, made worse by retaliatory tariffs on U.S. farm products. And the oil and gas sector is facing another sharp decline in oil prices. While this sector has expanded dramatically since the early 2000s thanks to fracking and the related shale oil revolution, sharp oil price fluctuations have led to a boom-and-bust cycle that may be repeating itself.

To summarize, labor markets are tight, inflation is low and stable, and economic growth is expected to slow to a rate close to the economy's longer-run growth potential. Notwithstanding both upside and downside risks, the outlook for the economy appears favorable.

Implications for monetary policy

With this background, let me turn to the matter of monetary policy. Since the beginning of the interest rate normalization process in December 2015, the Federal Reserve has raised rates 225 basis points, removing much of the policy accommodation that was put in place during the financial crisis and Great Recession.

So, are we there yet? Has the FOMC raised rates back to a neutral or normal level so that they are no longer either stimulating or restraining economic activity? Have we reached the proverbial soft landing where the economy has achieved maximum employment, stable prices, growth at potential, and monetary policy neutrality? In my view, we are not there just yet. However, we are close and for now, it seems to me that we should proceed with caution and be patient as we approach our destination.

As the year unfolds, I will be looking for signals from the economy in a number of areas that will determine my policy choices. My position on whether to further increase rates or stay where we currently are will depend on several factors. If, for example, the inflation outlook remains benign despite tight labor markets or if the downside risks I spoke of earlier materialize, we can pause the normalization process. On the other hand, if inflation pressures emerge, it would suggest we are further away from neutral than we may have previously thought and further interest rate increases could be necessary.

In judging future economic conditions, I am mindful that the effects of past policy actions have not yet fully played out, calling for patience in considering our policy actions. As the famous economist Milton Friedman observed, monetary policy acts with "long and variable lags." Typically, policy moves affect real economic activity with a lag of six months to a year and inflation in one to two years. Given the cumulative 225 basis points of tightening—100 basis points of which occurred last year—we have likely not yet seen the full effect of higher rates on real economic activity or inflation. A pause in the normalization process would give us time to assess if the economy is responding as expected with a slowing of growth to a pace that is sustainable over the longer run. Failure to recognize these lags could lead to an over-tightening of policy, a downturn in economic growth and an undershooting of our inflation objective.

These issues are made all the more difficult by a fact that I mentioned earlier in my remarks—the map guiding us is incomplete. We do not know precisely the location of our destination: that is, the longer-run neutral value of the federal funds rate. Recall that the neutral rate is the rate that neither stimulates economic activity nor restrains it. Participants at last month's FOMC meeting gave a range of estimates of the longer-run federal funds rate from 2½ percent to 3½ percent with a median of 2.8 percent. With the funds rate target currently at 2¼ to 2½ percent, we are near the lower end of the range of our estimates of neutral. And complicating our reliance on these estimates is that, in the background, we are gradually reducing the size of our balance sheet, allowing assets to roll off as they mature. It is unclear whether, or how much, this roll off is further removing accommodation. Again, this suggests it might be a good time to pause our interest rate normalization, study the incoming evidence and data, and verify our current location.

A final reason to show patience around further rate adjustments is that a number of key economic relationships that have guided policy over the years may have broken down in the aftermath of the financial crisis and Great Recession. Structural changes in the economy such as the aging of the population, sluggish productivity growth, business sector consolidation, rising government deficits and debt, and historically low interest rates have potentially rendered past guideposts to policy less reliable. In addition, central banks in other parts of the world, like the Federal Reserve, undertook massive asset purchase programs to address the financial crisis, and are now beginning to confront the need to shrink their balance sheets. These central bank interventions may be changing the structure of financial markets in unknown and unpredictable ways.

One relationship, for example, that has confounded economists and policymakers over the past several years is that of inflation and economic slack. As mentioned earlier, when the unemployment rate falls below its natural rate, we generally expect inflation to rise. But despite unemployment falling well below most estimates of the natural rate, inflation has remained subdued. This raises questions about whether our estimate of the natural rate is too pessimistic and whether the economy can operate at a lower unemployment rate today than in the past without sparking inflationary pressures. This is another area where I will be looking for feedback from the economy to assess whether we might need to revise our estimates of the natural rate.

To this mix, I would add any number of additional real and financial market indicators to monitor closely for evidence that monetary policy is approaching neutral and that the pace of normalization should change. Gauging the appropriate policy response will also importantly be shaped by analysis from my staff and input from a wide range of contacts who have on-the-ground knowledge of financial conditions, price pressures, and the outlook for economic activity.

Conclusion

Earlier in the normalization process, the FOMC provided forward guidance suggesting that monetary policy was accommodative and that gradual interest rate increases would be consistent with achieving our goals. Given current economic conditions, providing such explicit guidance now about the future path of policy rates would not be appropriate in my view.

Back then, policy was some distance from a neutral setting and we had not fully realized our objectives for employment and inflation, and thus the direction of policy was clear. Today, circumstances are different. While my policy view always depends on the flow of data, this year we must acknowledge that rates are approaching, and may be closing in on, our destination of neutral. We should also remain sharply aware that the effects of past rate increases, while dissipating, are still in play and the effects will need to be watched carefully.

It is possible that some additional rate increases will be appropriate. But making that judgment is not urgent and should depend on a careful look at the data and gathering additional insight into where our destination is, how much further we need to go to reach it and how quickly we should get there.