Lael Brainard: The US economic outlook and implications for monetary policy

Speech by Ms Lael Brainard, Member of the Board of Governors of the Federal Reserve System, at the Center for Strategic and International Studies, Washington DC, 2 June 2015.

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This spring marks the end of the Federal Reserve's calendar-based forward guidance and the return to full data dependency in the setting of the federal funds rate. So it is notable that just as policymaking is becoming more anchored in meeting-by-meeting assessments of the data, the data are presenting a mixed picture that lends itself to materially different readings.[1]

No doubt, bad weather, port disruptions, and statistical issues are responsible for some of the softness in first-quarter indicators of aggregate spending. Indeed, it may be that the dismal estimate by the Bureau of Economic Analysis of the annualized change in first-quarter gross domestic product (GDP), negative 0.7 percent, is principally an extension of the pattern, seen for several years, of significantly slower measured GDP growth in the first quarter followed by considerably stronger readings during the remainder of the year. In that case, it would be appropriate to minimize the importance of the first-quarter estimate in judging the likely path of the economy over the remainder of the year.

But there may be reasons not to ignore the recent readings entirely. First, the limited data in hand pertaining to the second quarter do not suggest a significant bounceback in aggregate spending, which we would expect if all of the weakness in the first quarter were due to transitory factors. Private-sector forecasts of second-quarter growth are centered around 2–1/2 percent, while the Federal Reserve Bank of Atlanta's GDPNow forecast, which was quite accurate in its prediction of the first estimate of first-quarter GDP growth, is projecting second-quarter GDP growth of only 0.8 percent.[2]

Second, it would not be the first time this recovery has proceeded in fits and starts. The underlying momentum of the recovery has proven relatively susceptible to successive headwinds, which have kept overall economic growth well below the average pace of previous upturns.

My own reading is that earlier, more optimistic growth projections may have placed too much weight on the boost to spending from lower energy prices and too little weight on the negative implications for aggregate demand of the significant increase in the foreign exchange value of the dollar and large decline in the price of crude oil.

Turning first to the expected positive effects, at a time when a lot of the growth burden is riding on U.S. consumers, consumers appear to be disinclined to spend much of the gains from cheaper prices at the pump, preferring, it seems, to strengthen household balance sheets instead. Relative to expectations predicated on the boost to real income from lower gas prices, consumer spending so far this year has been undeniably weak, especially given a backdrop of improving labor market prospects, solid consumer sentiment, and improving credit availability. Consumer spending is reported to have increased at an annual rate of only 1.8 percent in the first quarter – far below the 5.3 percent increase in household real disposable income. Moreover, monthly data on expenditures through April do not suggest a large bounceback going into the second quarter.

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[1] As always, these remarks represent my own views, which do not necessarily represent those of the Federal Reserve Board or the Federal Open Market Committee.

[2] For details on the most recent private-sector forecasts, see Aspen Publishers (2015), *Blue Chip Financial Forecasts,* vol. 34, no. 6 (June 1). More information about the GDPNow forecast is available on the Federal Reserve Bank of Atlanta's website.

Continuing softness in consumption this year would naturally raise some questions about a more persistent change in consumer behavior. For example, the financial crisis may have altered expectations of longer-run income growth and attitudes toward risk such that consumers may be more cautious about spending gains in income and wealth that are perceived to be temporary.

Modest growth in consumer spending would be significant because strength in other categories of aggregate demand remains elusive. Although the data on April housing starts and permits look promising, the current level of single-family housing permits is little changed from the level in the fourth quarter of last year, and average growth in residential investment over the past year and a half has been tepid. Given low interest rates and continued job gains, it is puzzling that housing starts have remained far below the trend levels implied by population growth. Tight credit for borrowers with less-than-pristine credit may explain some of the weakness. But it is also possible that attitudes toward homeownership have changed as a result of the financial crisis and recent recession, especially among the millennial Great Recession generation.

Meanwhile, government spending has contributed very little, on average, to GDP growth in recent quarters. With the Budget Control Act of 2011 restraining federal outlays and with pension and health-care obligations limiting expenditures at the state and local level, the public sector is not likely to contribute significantly to GDP growth over the next few years.

Just as the positive effects appear to have been more muted than expected, so, too, the negative effects from the substantial decline in the price of oil and appreciation of the exchange rate on business investment, manufacturing, and exports seem to have been greater than expected. In response to the drop in oil prices, drilling activity is reported to have fallen at an annual rate of nearly 50 percent in the first quarter, and data on drilling rigs in operation suggest another large decline this quarter.

At the same time, the dollar’s rise is reducing net exports, and perhaps restraining investment in areas sensitive to foreign demand, with greater force than anticipated. Net exports subtracted 1 percentage point from GDP growth in the fourth quarter and a whopping 1.9 percentage points in the first quarter. This large decline likely reflects more than exchange rate appreciation alone, but some drag on net exports from exchange rate appreciation is likely to persist. Indicators of business equipment spending – such as orders and shipments of capital goods, as well as business sentiment – have also been weak, suggesting that overall business investment will change little over the first half of the year.

Other indicators also suggest a negative effect on manufacturing activity from foreign headwinds. The Institute for Supply Management (ISM) national manufacturing diffusion index of new export orders has been in contractionary or neutral territory for four of the past five months. Manufacturing production declined at an annual rate of 1 percent in the first quarter, and the outlook for internationally oriented firms has worsened appreciably recently.

Of course, there is a danger in reading too much into these data. Indicators, such as the ISM’s nonmanufacturing composite index, suggest that activity has remained solid in the private services sector, which accounts for the bulk of economic activity. It is possible that we will soon see the stronger trend in domestic economic activity that was apparent in the second half of last year reassert itself. In assessing this possibility, it is important to keep in mind the international context, which I will turn to next.

International context

The notable effects of recent crosscurrents from abroad should lay to rest any remaining lore that the United States is a closed economy. Financial linkages between the United States and foreign economies are immediate and extensive. Equity prices, long-term interest rates and risk spreads, and exchange rates show strong reactions to developments abroad, and, in recent months, foreign developments have at times been the dominant factor driving U.S.

financial conditions. Weak foreign aggregate demand, as well as accompanying accommodative monetary policies in the euro area and Japan, and diverging expectations have been key among the factors causing a significant 10 percent appreciation of the dollar since last June. To the extent that exchange rate appreciation exerts a tightening force on financial conditions in the United States, it delays the return of U.S. interest rates to more normal levels.

While trade is a smaller share of the U.S. economy than in many other economies, exchange rate changes of the magnitude seen recently can have large effects on aggregate demand.[3] We have already seen a large negative contribution of net exports to U.S. GDP growth in the past two quarters. In addition, because some models estimate that exchange rates' effect on net exports can last up to three years, it is possible that the drag from net exports will persist for some time. Even before the latest estimate of the first-quarter contribution of net exports to GDP was published, many private-sector forecasters (as well as the Congressional Budget Office) expected net exports to subtract from GDP growth this year and next.

Recently, the euro area has seen some encouraging data on retail sales, industrial production, and inflation, auguring well for some sustained improvement in aggregate demand within the euro area. Nonetheless, there remain risks and uncertainties surrounding foreign growth that could prolong or intensify foreign headwinds going forward.

Most immediately, negotiations between Greece and its creditors are challenging, and the risk of further deterioration cannot be ruled out. While the euro area has broadened its policy toolkit and most member states have made significant strides in building resilience in the past couple of years, the recovery is still fragile in several member states, and vulnerabilities to financial stresses remain.

In addition, Chinese GDP growth looks to have slowed noticeably in the first quarter, and there is some risk of further slowing. This development reflects in part a significant correction in the property market and the shadow banking sector following years of rapid growth. But structural factors are also at work. After growing at a nearly double-digit rate for more than three decades, China has reached a transitional phase in which potential output growth is expected to slow in part because of challenging demographics and the transition from heavy reliance on exports and investment toward greater dependence on household demand.

Ultimately, lower interest rates abroad should boost domestic demand in the euro area and Japan, which could eventually be a net positive for U.S. net exports. But the most immediate effect appears to be a shift in asset demand toward countries with relatively higher expected interest rates, such as the United States.

Inflation, employment, and the implications for monetary policy

Foreign headwinds also appear to be affecting U.S. inflation. Weak foreign demand appears to be the dominant factor driving recent reductions in the prices of some non-oil commodities and also likely played some role in last year's decline in oil prices, although changes in supply are likely the more important driver.

The stronger dollar is also weighing on U.S. inflation through lower import prices. Non-oil import prices are reported to have declined at an annual rate of 4–1/2 percent last quarter, and data on trade prices through April suggest a decrease of a similar magnitude this quarter. Based on the share of imports in consumption, econometric models imply that falling import prices might subtract about 0.3 percentage point from consumer price inflation this year.

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3 In addition, an increase over time in import and export shares will increase the effect of exchange rate changes on real GDP even if the export and import elasticities have not changed.

Starting this month, with the end of calendar-based forward guidance, the decisions of the Federal Open Market Committee (FOMC) regarding the level of the federal funds rate will depend on the evolution of incoming economic data. While the date of liftoff will not be predetermined, the conditions governing the decision to lift off have been clearly stated. First, to have reasonable confidence that inflation will be on track to reach its target of 2 percent over the medium term, I will be looking closely at a variety of indicators – in particular, signs that core inflation is firming, deflationary pressures from abroad are abating, and both survey- and market-based measures of inflation expectations are stable.

Despite the deflationary pressures from abroad, the recent data have provided some reassurance that inflation in the United States is starting to firm. Oil prices have now retraced part of their decline from the middle of last year through January, and monthly changes in core personal consumption expenditures (PCE) prices have increased from the very low levels reached around the turn of the year.

In the face of the long period of weak overall inflation, it is reassuring that survey-based measures of longer-run inflation expectations appear to have remained stable. In addition, market-based measures of inflation expectations have moved up somewhat in the past few months after several months of decreases that appeared to have been associated with oil price declines and heightened anxiety about global deflationary pressures. Even so, most indicators of the underlying trend in PCE inflation, such as the 12-month change in core PCE prices or the Federal Reserve Bank of Dallas's 12-month trimmed mean PCE inflation rate, are around 1–1/4 to 1–1/2 percent, noticeably below the FOMC's 2 percent target.

Second, I will also want to see further improvement in the labor market with solid further employment growth and further evidence of a narrowing of resource utilization gaps based on various indicators, including the unemployment rate, the labor force participation rate, the percentage of employees who are working part time for economic reasons, and faster wage growth.

The robust pace of labor market improvement was perhaps the brightest part of the data picture over 2014. As we have advanced into 2015, the pace of job gains has slowed. Average monthly nonfarm payroll employment gains in the past three months were a little under 200,000, down from last year's pace of 260,000. Even so, job gains still appear to be consistent with declining labor market slack, as do indicators such as unemployment insurance claims and job openings, which remain robust.

My judgment is that there is still room for employment and hours worked to grow further, as there are other labor market indicators that suggest slack not captured by the unemployment rate. For example, the labor force participation rate remains low relative to its declining pre-crisis trend, and the number of employees who are working less than they would like is still elevated relative to pre-crisis standards. Moreover, on balance, aggregate measures of wage growth remain soft and have not significantly strengthened in the past year, suggesting there is remaining slack in the labor market.

In addition, although the unemployment rate is now near levels commonly associated with the natural rate of unemployment, there are reasons to think that the natural rate may have declined over the past few years such that a gap remains between the unemployment rate and its natural rate. The composition of the labor force, for example, looks to be shifting toward groups with relatively low levels of unemployment.[4] In addition, it may be that a

[4] For more details on the composition of the labor force, see Daniel Aaronson, Luojia Hu, Arian Seifoddini, and Daniel G. Sullivan (2015), "Changing Labor Force Composition and the Natural Rate of Unemployment (PDF)," Chicago Fed Letter, no. 338 (Chicago: Federal Reserve Bank of Chicago, May).

reduction in worker bargaining power or perhaps reduced levels of labor market churning are putting downward pressure on the natural rate.[5]

With the labor market evidencing additional slack not well captured by the standard unemployment rate and with inflation remaining soft, there may be additional room to support further healing in the labor market, which is appropriate following the deep damage from the Great Recession.

Given the softness in the data we have seen so far this year and some uncertainty about how much to attribute to temporary or statistical factors, I think there is value to watchful waiting while additional data help clarify the economy's underlying momentum in the face of the headwinds from abroad. If continued labor market strengthening is confirmed and inflation readings continue to improve, liftoff could come before the end of the year.

It is important to underscore, however, that the date of liftoff is only one in an ongoing series of decisions the FOMC will be making in response to incoming data. Just as no previous recovery has proceeded as this one has, so, too, there is no reason to expect monetary policy to follow previous tightening cycles. Given the unique conditions in the labor market and the economy more broadly, I will want to move step by step – observing how the markets and the economy respond before gauging the appropriate next step in the policy path.

The divergence in conditions here and abroad also injects an element of uncertainty with regard to the path of policy. While, as noted earlier, the dollar's appreciation is generally transmitted into somewhat tighter financial conditions, the advent of quantitative easing in Europe appeared to have led to some compression in term premiums not only in European bond markets, but also in the United States. Although longer-dated yields have recently moved somewhat higher, it is nonetheless difficult to know in advance how term premiums will respond when U.S. normalization gets under way. To the extent that the commencement of normalization leads to relatively greater demand for U.S. assets, we could see echoes of the so-called conundrum in the period from 2004 to 2005, when rising short-term rates were accompanied by falling forward rates. But the reverse is also possible, with term premiums moving more steeply than appropriate for underlying economic conditions, which we saw in the so-called taper tantrum episode in 2013.

Certainly, my colleagues and I are mindful of recent episodes in which we have seen unusually sharp spikes in market volatility. Accordingly, I expect that the FOMC will continue proceeding to the greatest extent possible in a very deliberate manner, aiming to provide clear communications about Committee members' assessments of the economic and policy outlook.

Based on today's picture of moderate underlying momentum in the domestic economy and the likelihood of continued crosscurrents from abroad, the process of normalizing monetary policy is likely to be gradual. It is also important to remember that the stance of monetary policy will remain highly accommodative even after the federal funds rate moves off the effective lower bound, because the real federal funds rate will initially still be low and because of the elevated size of the Federal Reserve's balance sheet and the associated downward pressure on long-term rates. Moreover, the FOMC has stated clearly that it will

[5] For a discussion of the effects of worker bargaining power on the natural rate, see Andrew Figura and David Ratner (forthcoming), "The Labor Share of Income and Equilibrium Unemployment," FEDS Notes (Washington: Board of Governors of the Federal Reserve System). For a discussion of the effect of labor market churning on the unemployment rate, see Steven J. Davis, R. Jason Faberman, John Haltiwanger, Ron Jarmin, and Javier Miranda (2010), "Business Volatility, Job Destruction, and Unemployment," *American Economic Journal: Macroeconomics,* vol. 2 (April), pp. 259–87; and Michael Feroli (2014), "U.S.: The Consequences of Economic Calcification," J.P. Morgan Economic Research Note (New York: JPMorgan Chase, September), as noted in James Pethokoukis (2014), "America Suffering from 'Economic Calcification' – JP Morgan," *AEIdeas* (blog), September 2.

reduce the size of the balance sheet in a gradual and predictable manner starting at an appropriate time after liftoff, which will depend on how economic and financial conditions evolve.

In summary, the string of soft data in the first quarter raises some questions about the contours of the outlook. While it is possible that residual seasonality and temporary factors were responsible, it would be difficult, based on the data available today, to dismiss the possibility of a more significant drag on the economy than anticipated from foreign crosscurrents and the negative effects of the oil price decline, along with a more cautious U.S. consumer. This possibility argues for giving the data some more time to confirm further improvement in the labor market and firming of inflation toward our 2 percent target. But while the case for liftoff may not be immediate, it is coming into clearer view. When that time comes, the policy path will be highly attuned to incoming data and not on a preset course, and it is important to be mindful of the possibility of volatility as markets adjust to a change in the stance of policy. Thus, the FOMC will continue communicating as clearly as possible regarding the outlook and the factors underlying its policy determinations.