U.S. Economic Outlook

Kei-Mu Yi
Federal Reserve Bank of Minneapolis

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The views expressed here are those of the author and not necessarily those of the Federal Reserve Bank of Minneapolis or the Federal Reserve System.

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Outline

1. Federal Reserve 101
   a. Structure, Goals, and Tools

2. Recent performance of U.S. economy
   a. Why has recovery been so slow?
   b. Fed’s role in offsetting Great Recession and strengthening recovery

   a. Risks
Federal Reserve 101
Federal Reserve System: Structure

1. Board of Governors (Washington, D.C.)
2. Twelve Reserve Banks, each representing a geographic district
   a. 9th District includes Minnesota, Montana, North Dakota, South Dakota, and parts of Michigan and Wisconsin
      i. Branch office in Helena, Montana
Federal Reserve System: Functions

1. Supervise banks to ensure their safety and soundness
2. Operate parts of payments system
3. Conduct monetary policy to achieve goals mandated by Congress
Federal Reserve System: Federal Open Market Committee (FOMC)

1. Conducts monetary policy
2. Voting members:
   a. Board of Governors (7 at full strength)
   b. Rotating group of presidents from Reserve Banks (5)
Federal Reserve System: Monetary Policy Mandate and Goals

Dual mandate (set by Congress):

1. Maintain stable prices
   • Since 2012, FOMC has interpreted “stable prices” as 2% inflation rate (as measured by personal consumption expenditures (PCE) deflator)
2. Maximize employment
   • No specific numerical target

Federal funds rate (FFR) was primary monetary policy tool

1. Short-term (overnight) interest rate
2. Raising FFR tends to reduce inflation and employment*
3. Lowering FFR tends to raise inflation and employment*

*Assuming that inflation expectations are stable
Recent Performance of U.S. Economy
Recent GDP growth unusually slow

Real Gross Domestic Product, percent change from a year earlier

Source: Bureau of Economic Analysis
Unemployment rate declining, but ...

Unemployment rate, percent

Source: Bureau of Labor Statistics
... Employment-population ratio shows little improvement

Source: Bureau of Labor Statistics
Even adjusting for demographics, EPOP shows little improvement

Employment-population ratio: 25-54 years, percent

Source: Bureau of Labor Statistics
Also, part-time workers wanting to work full-time still large

Source: Bureau of Labor Statistics
Recent inflation subdued …

Source: Bureau of Economic Analysis
… Headline inflation still below 2%

Personal Consumption Expenditures Price Index, 12-month percent change

Source: Bureau of Economic Analysis
Why Has Recovery Been So Slow?

1. Headwinds
   - Uncertainty about economy and policy
   - Fiscal “drag”
   - Tight credit and debt overhang

2. Structural Forces
   - Declining labor force participation
   - Lower productivity growth
Federal, state, and local government spending on goods and services declined

Q/Q(-4) percent change in real government consumption and gross investment

Source: Bureau of Economic Analysis
Labor force participation rate peaked 14 years ago

Civilian labor force participation rate: 16 years and over, percent

Source: Bureau of Labor Statistics
Federal Reserve Policy in Recent Years
Federal Reserve’s Policy Actions

1. To achieve dual mandate during Great Recession and its aftermath, Fed initially used its conventional tool, the federal funds rate (FFR)
   • Fed lowered FFR to zero by late 2008
Federal funds rate

Source: Board of Governors, Federal Reserve System
Federal Reserve’s Unconventional Policy Actions

1. However, employment recovered slowly, and inflation was low and stable
2. Under these conditions, more monetary stimulus called for
3. Since late 2008, Fed has pursued two types of unconventional monetary policy
   a. Forward guidance
   b. Large-scale asset purchases (LSAPs)
Forward Guidance

Focuses on communicating conditions under which, and for how long, the federal funds rate will remain at zero:

- Fed “In determining how long to maintain the current 0 to 1/4 percent target range for the federal funds rate, the Committee will assess progress--both realized and expected--toward its objectives of maximum employment and 2 percent inflation. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. The Committee continues to anticipate, based on its assessment of these factors, that it likely will be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal, and provided that longer-term inflation expectations remain well anchored.”
Large-Scale Asset Purchases (LSAPs)

Purchases of government-issued or -backed long-term securities:

- Fed purchased long-term Treasury securities and government guaranteed mortgage-backed securities (MBSs)
- Goal was to drive down long-term interest rates, which would then stimulate capital investment, purchases of autos and homes, and economic activity more broadly
- Fed is currently “tapering” its purchases, and will eventually cease further purchases, assuming economy continues to perform as expected
- Nevertheless, Fed’s balance sheet has almost quintupled in size since late 2007
Outlook for U.S. Economy
U.S. Outlook: Headwinds Continue to Diminish

Recovery continues and strengthens as:
1. Uncertainty about economy and policy continues to diminish
2. Fiscal drag wears off
3. Credit continues to become more accessible
Credit standards for business borrowers becoming less tight

Net Percentage of Domestic Respondents Tightening Standards for Commercial and Industrial Loans

Source: Senior Loan Officer Opinion Survey, Board of Governors of the Federal Reserve System
Credit standards for consumer loans becoming less tight

Source: Senior Loan Officer Opinion Survey, Board of Governors of the Federal Reserve System
GDP growth expected to be stronger in second half of 2014 and into 2015

Summary of Economic Projections, FOMC, June 2014

Sources: Bureau of Economic Analysis, Board of Governors of the Federal Reserve
Note: Figure presents mid-point of "central tendency" of FOMC projections.
Unemployment expected to continue to gradually decline

Sources: Bureau of Economic Analysis, Board of Governors of the Federal Reserve
Note: Figure presents mid-point of “central tendency” of FOMC projections.
Inflation expected to gradually converge back to 2% target

Personal Consumption Expenditures Price Index, 12-month percent change

Sources: Bureau of Economic Analysis, Board of Governors of the Federal Reserve
Note: Figure presents mid-point of "central tendency" of FOMC projections.
Risks to Outlook

1. No rebound in demand
2. Inflation surpasses 2%
3. Financial instability
4. Global
   - China
   - Europe
   - Geopolitical
Summary and Conclusion

1. Recovery has been slow, but it has been sustained
2. Fed has undertaken unconventional policies to help achieve price stability and maximum employment
3. Outlook calls for:
   - Continued moderate recovery in GDP and employment
   - Gradual convergence of inflation back to 2 percent
4. Beyond near-term, structural forces should play larger role in medium-term
Appendix
... Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee expects that, with appropriate policy accommodation, economic activity will expand at a moderate pace, with labor market indicators and inflation moving toward levels the Committee judges consistent with its dual mandate. The Committee sees the risks to the outlook for economic activity and the labor market as nearly balanced and judges that the likelihood of inflation running persistently below 2 percent has diminished somewhat.

The Committee currently judges that there is sufficient underlying strength in the broader economy to support ongoing improvement in labor market conditions. In light of the cumulative progress toward maximum employment and the improvement in the outlook for labor market conditions since the inception of the current asset purchase program, the Committee decided to make a further measured reduction in the pace of its asset purchases ... The Committee's sizable and still-increasing holdings of longer-term securities should maintain downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative, which in turn should promote a stronger economic recovery and help to ensure that inflation, over time, is at the rate most consistent with the Committee's dual mandate.

The Committee will closely monitor incoming information on economic and financial developments in coming months and will continue its purchases of Treasury and agency mortgage-backed securities, and employ its other policy tools as appropriate, until the outlook for the labor market has improved substantially in a context of price stability. If incoming information broadly supports the Committee's expectation of ongoing improvement in labor market conditions and inflation moving back toward its longer-run objective, the Committee will likely reduce the pace of asset purchases in further measured steps at future meetings. However, asset purchases are not on a preset course, and the Committee's decisions about their pace will remain contingent on the Committee's outlook for the labor market and inflation as well as its assessment of the likely efficacy and costs of such purchases ...
Excerpts from Latest FOMC Statement

… To support continued progress toward maximum employment and price stability, the Committee today reaffirmed its view that a highly accommodative stance of monetary policy remains appropriate. In determining how long to maintain the current 0 to 1/4 percent target range for the federal funds rate, the Committee will assess progress--both realized and expected--toward its objectives of maximum employment and 2 percent inflation. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. The Committee continues to anticipate, based on its assessment of these factors, that it likely will be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal, and provided that longer-term inflation expectations remain well anchored.

When the Committee decides to begin to remove policy accommodation, it will take a balanced approach consistent with its longer-run goals of maximum employment and inflation of 2 percent. The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run.
Survey of Professional Forecasters expects higher near-term GDP growth

Real GDP and forecast, 12-month percent change

Sources: Bureau of Economic Analysis, Philadelphia Fed and Minneapolis Fed
Survey of Professional Forecasters expects unemployment to continue to gradually decline.
Survey of Professional Forecasters expects inflation to converge steadily back to 2% target

Personal Consumption Expenditures Price Index and forecast, 12-month percent change

Sources: Bureau of Economic Analysis, Philadelphia Fed and Minneapolis Fed