William C Dudley: The US economic outlook and implications for monetary policy

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the People's Bank of China-Federal Reserve Bank of New York Joint Symposium, Hangzhou, Zhejiang, 29 February 2016.

*   *   *

Thank you, Deputy Governor Zhu, for the opportunity to speak at this inaugural People's Bank of China and Federal Reserve Bank of New York 2016 Joint Symposium. It is a wonderful occasion for our two central banks to meet and share ideas on important global macroeconomic and monetary policy issues.

It is especially satisfying to me to be here in Hangzhou to see the result of my discussion last February with Governor Zhou about this kind of policy and research exchange. I thank you and the staff of The People's Bank of China for developing this idea into such an ambitious work agenda, and for assembling such a distinguished group of contributors and participants for this symposium. We at the New York Fed look forward to future collaborative efforts to strengthen the relationship between our two institutions, especially given the key roles that China and the United States play in the global economy. By working together I believe we can achieve better outcomes for our countries and for the global economy. Today, although I will focus mainly on the U.S. economic outlook, I also will discuss how global economic and financial market developments factor into my thinking about U.S. monetary policy. As always, what I have to say today reflects my own views and not necessarily those of the Federal Open Market Committee (FOMC) or the Federal Reserve System.[1]

U.S. Economic Outlook

Recent economic and financial developments have not yet led me to make a fundamental change in my outlook for U.S. growth in 2016. At this point, I have marked down my growth outlook very modestly. However, financial market conditions have tightened since the start of the year, mostly in response to international developments. If this tightening of financial conditions were to persist, it could potentially lead to a more significant downgrade to my outlook.

I continue to expect that the economy will expand over the course of this year at a pace slightly above its long-term trend – sufficient to push the unemployment rate down a bit further and to more fully utilize the nation's labor resources. On inflation, we continue to fall short of our 2 percent objective for the personal consumption expenditure (PCE) deflator. This shortfall looks likely to continue longer than I had earlier anticipated due to the persistent strength of the dollar and weakness in energy prices. However, I continue to expect a gradual return to our 2 percent objective as the transitory factors that have held down inflation dissipate.

In assessing the current state of the U.S. economy, there are divergent signals, with weakness in some spending and production indicators, but robustness in a number of labor market indicators. In the fourth quarter, investment spending for both equipment and structures fell, and net exports and inventory investment were drags on growth. These developments partly reflect the slowing of global growth and the impact of the dollar's appreciation since mid-2014. This weakness has been particularly evident in U.S. manufacturing. However, the latest ISM non-manufacturing index suggests the possibility of a slower pace of growth also in the

---

[1] Matthew Higgins, Jonathan McCarthy, Paolo Pesenti and Joseph Tracy assisted in preparing these remarks.

services sector, which has been relatively robust. Consumer spending growth – which had been a brighter spot for most of 2015 – also slowed notably in the fourth quarter.

In contrast, the U.S. labor market has remained healthy and supportive of growth. Over the course of 2015, payroll employment increased an average of about 228,000 per month. Although the January increase of 151,000 was below last year's pace, other aspects of the report were strong. The January data indicated substantial gains in wages and hours worked, which implies healthy real income growth for the household sector. Moreover, the amount of slack in the labor market continues to diminish based on a number of measures. The unemployment rate declined to 4.9 percent. This was accompanied by further declines in both the share of people working part-time that would like full-time work, as well as the share of people not part of the labor force. Consistent with a tighter labor market, the share of the working-age population that is employed has risen gradually, and the labor force participation rate has stabilized.

While the weakness in some indicators has led me to make small reductions in my forecast, my overall outlook has not changed substantially. In making this determination, a central question is how to reconcile these cross-currents. One has to also factor in that the real GDP growth rate in the fourth quarter was only 1.0 percent and the four-quarter change was 1.9 percent – low even by the subdued standards of this expansion. It is important, though, to recognize that a number of transitory factors held down growth in the fourth quarter – most notably lower utility spending due to warm weather and a decline in the rate of inventory investment.

As these transitory factors depressing the pace of economic growth dissipate, the core strengths for the economy should reassert themselves. I anticipate that consumption and housing activity will expand at a moderate pace. Continued job and wage gains, as well as low energy prices, should support real disposable income growth and consumer spending. Retail sales in January provide evidence of this support. The housing market should remain on a solid trajectory, supported by rising employment and low mortgage rates. In addition, the fiscal 2016 budget package passed at the end of last year, which extended a number of tax breaks and eased caps on spending, means that fiscal policy should provide a moderate stimulus this year. I believe that these positive factors should be sufficient to offset weakness in manufacturing and business-fixed investment.

Putting this all together, I expect real GDP growth of about 2 percent in 2016, slightly below the average pace of growth in this expansion, and a bit above my estimate of the potential growth of the U.S. economy. If this materializes, then we should see some further reduction in the unemployment rate to around my estimate of the rate – about 4¾ percent – that I view as consistent with stable inflation over the long term.

Turning to the outlook for inflation, headline inflation on a year-over-year basis has begun to rise as the sharp falls in energy prices in late 2014 and early 2015 are removed from the calculations. However, inflation still remains well below the Federal Reserve's 2 percent objective. As the FOMC has noted in its statements, this continued low inflation is partly due to recent further declines in energy prices and ongoing impacts of a stronger dollar on non-energy import prices. Although energy prices will eventually stop falling and the dollar will stop appreciating, these factors appear to have had a more persistent depressing influence on inflation than previously anticipated.

This continued period of low headline inflation is a concern, in part, because it could lead to significantly lower inflation expectations. If this drop in inflation expectations were to occur, it would, in turn, tend to depress future inflation. Evidence on the inflation expectations front suggests some cause for concern. In particular, market-based measures of longer-term inflation compensation derived from nominal and inflation-indexed Treasury securities have fallen to very low levels. In addition, some survey measures of household inflation expectations have recently moved lower.

With respect to the market-based measures, there are some reasons to discount the decline. Several term structure models, including those estimated at the New York Fed, attribute most of this decline to a decrease in term premiums – what investors demand for insurance against inflation risks – and not to a decrease in long-term inflation expectations. These models suggest that, over the indicated horizon, investors anticipate that low growth will occur along with low inflation. Still, given the extent to which inflation compensation has fallen since mid-2014, I believe that it is prudent to consider the possibility that longer-term inflation expectations of market participants may have declined somewhat.

What I find more concerning is the decline in some household survey measures of longer-term inflation expectations. For example, the median of three-year expectations from the New York Fed's Survey of Consumer Expectations has declined over the past year to its lowest reading in the survey's short history, and the longer-running University of Michigan measure is at the bottom of its historical range. Further declines in either measure would be worrisome. To date, these declines have not been sufficiently large for me to conclude that inflation expectations have become unanchored. However, these developments merit close scrutiny, as past experience shows that it is difficult to push inflation back up to the central bank's objective if inflation expectations fall meaningfully below that objective. Japan's experience is cautionary in this regard.

In sum, I still anticipate that the combination of decreasing resource slack and anchored longer-term inflation expectations will contribute to inflation rising to our 2 percent objective over the medium term. Even so, because of the more persistent effects of energy and commodity price declines and U.S. dollar appreciation, the return of inflation to that goal may be slower than I earlier anticipated. This does not deny the possibility of some upside surprise—such as a sharp upswing in wage growth triggered by low unemployment. But, on balance, I am somewhat less confident than I was before. Partly, this reflects my assessment that uncertainty to the outlook has increased and that downside risks have crept up, a topic to which I now turn.

Assessment of Risks to the Outlook

The forecast that I have just described is my best assessment of how the U.S. economy will evolve over 2016. But there is uncertainty and risk relative to this baseline forecast, which also needs to be taken into consideration in assessing the implications of the outlook for monetary policy.

There are two key considerations to this risk assessment. First, are the perceived uncertainties about the forecast higher, lower or about average as compared to the past? Second, are the risks symmetric around the baseline forecast or skewed upward or downward? The level of uncertainty is important in that it relates to the expected magnitude of forecast errors. The balance of risks is important in that it relates to the expected sign of those forecast errors.

At the New York Fed, we use surveys, internal models and judgment in forming our risk assessment. Some surveys, such as the U.S. Survey of Professional Forecasters (SPF), ask respondents for both point and density forecasts. The density forecasts take the form of respondents filling out a histogram of their probability assessments that the forecasted outcome will fall into given intervals. These histograms can be aggregated and the resulting aggregate distribution can be used to assess both the level of uncertainty as well as the balance of risks. Recent U.S. SPF surveys have not indicated any significant changes in the overall degree of uncertainty around growth or inflation. The balance of risks have been roughly symmetric for inflation and tilted to the downside for growth.

We supplement this survey evidence with assessments from internal models. These models are data-driven and estimate percentiles of the distribution of possible forecast outcomes for growth and inflation. Our estimated models have indicated a greater degree of uncertainty than reflected in the U.S. SPF, and suggest downside risk to both the growth and inflation forecast.

But, I would caution that these models are still relatively new in terms of their development and their results need to be supplemented by judgment.

Now, putting these inputs and my judgment together, I see the uncertainties around my forecast to be greater than the typical levels of the past. This assessment reflects the divergent economic signals I highlighted earlier, and is consistent with the turbulence we have seen in global financial markets. At this moment, I judge that the balance of risks to my growth and inflation outlooks may be starting to tilt slightly to the downside. The recent tightening of financial market conditions could have a greater negative impact on the U.S. economy should this tightening prove persistent and the continuing decline in energy and commodity prices may signal greater and more persistent disinflationary pressures in the global economy than I currently anticipate. I am closely monitoring global economic and financial market developments to assess their implications for my outlook and the balance of risks.

U.S. Monetary Policy in a Global Environment

Thus far, my remarks have focused on the U.S. outlook and the risks relative to this outlook. This focus is appropriate. Like other central banks, our monetary policy mandate concerns domestic objectives: maximum sustainable employment and price stability. Our monetary policy actions, however, often have global consequences that, in turn, influence the U.S. economy and financial markets. At the same time, external factors can impact the monetary policy transmission mechanism in the U.S. and influence the effectiveness of our monetary policy in achieving our objectives. We cannot appropriately calibrate policy without keeping these spillover and feedback effects in mind.

In some cases, these effects can be significant. An example is the market volatility we saw in the spring and summer of 2013 during the so-called “taper tantrum.” In the U.S., we saw a spike in Treasury yields, with the 10-year rate rising by more than 100 basis points from early May of that year before peaking in September. Financial markets in emerging market economies (EME) were hit hard as well, with declines in equity prices, a widening in sovereign debt spreads and a sharp increase in foreign exchange volatility.

Volatility in EME financial markets re-emerged last summer and has continued into this year. For EMEs as a group, declines in equity prices and currency values have been larger than what we experienced during the taper tantrum. The recent episode, however, appears to largely reflect concerns about risks emanating from EMEs themselves, rather than concerns about the direction of Fed policy.

Three related concerns appear to be at the forefront. First, there has been a broad-based slowdown in EME growth. This slowdown is not new. Each year since 2012, EME growth has come in well short of expectations that existed at the start of the year. It is difficult, however, for market participants to recognize and adjust to large structural shifts in real time. There is still considerable uncertainty about the trajectory of long-term EME growth, and therefore the appropriate pricing of EME financial assets. In that context, heightened market volatility is not surprising.

Second, this slowdown in EME growth is happening after a long upswing in credit expansion in these countries. Based on BIS data for 23 of the largest EMEs, since the end of 2007 credit to their private nonfinancial sectors has risen from roughly 80 to 135 percent of GDP. In several countries, the increase in private credit penetration exceeds 40 percent of GDP – roughly the same order of magnitude that we witnessed in other periods that preceded financial crises. Although the magnitude of the EME credit boom has been apparent for some time, with EME growth now on a more subdued trajectory and the global financial environment less forgiving, market participants have begun to sharpen their focus on the risk of larger than expected credit losses as the credit cycle reverses.

Third, China has entered a period of economic transition, from a growth model based on investment, manufacturing and rapid state-directed credit growth to one emphasizing consumption, services and more sustainable market-directed credit intermediation. This transition also involves a downshift in China's trend growth rate, which is inevitable given the level of economic development in China and the shrinking margin of underutilized labor market resources. Economic transitions are always difficult to manage, and invariably present policymakers with unexpected challenges. It is not surprising, then, that market participants are focused on the risk that the downshift in Chinese growth could prove to be more pronounced than anticipated. I want to be clear. The rebalancing process now underway in China is both necessary and appropriate, and will unfold over a period of years. How to pragmatically strike the best balance between progress on long-term reform and support for short-term growth is, of course, a matter for policymakers in China. You can be sure that you will have the backing of the official international community as you oversee this important transformation.

Finally, the slowdown in Chinese and broader EME growth has been a key factor behind the sharp drop in global commodity prices since mid-2014. The income streams accruing to commodity export countries have been adversely impacted, requiring sometimes painful downward adjustments in investment and economic activity in these countries. Here, too, it may take time for markets to find a new equilibrium, as investment projects that were based on the price structure prevailing a few years ago are still coming online.

In most cases, EMEs appear to have the tools and the resources to help manage their way through the current period of difficulties. There are fewer of the pegged exchange rate regimes that often came violently undone during past periods of acute market stress. Monetary policy regimes are generally better structured and more coherent. Banking systems are better capitalized and supported by stronger regulatory and supervisory frameworks. Foreign exchange reserve cushions are larger and generally still ample. I think we can remain cautiously optimistic about EMEs' prospects overall in the years ahead, although particular countries will face considerable challenges over the near term.

How will we at the Fed take in and respond to these developments? As I've already noted, foreign developments factor into our assessment of the U.S. outlook. Recent FOMC statements have sometimes made this connection explicit, noting that the Committee will be monitoring foreign economic and financial conditions closely. The weakness we have been seeing in EME economies and markets is one of the considerations behind the Committee's assessment that the appropriate pace of policy normalization is likely to be gradual.

The federal funds rate is only one element of the broader set of financial conditions affecting the U.S. growth and inflation outlook. Tighter financial conditions abroad do spill back into the U.S. economy, and policymakers must take this into account in their assessment of appropriate monetary policy. Of course, this does not mean that we will let market volatility dictate our policy stance. There is no such a thing as a "Fed put." What we care about is the country's growth and inflation prospects, and we take financial market developments into consideration only to the extent that they affect the economic outlook.

Our focus on the global implications of our policies also has a broader dimension. Given the central place of U.S. markets in the global financial system and the dollar's status as the leading global reserve currency, we in the United States have a special responsibility to be good stewards of the global economic commons. This makes it all the more important that we conduct policy transparently and according to clear principles.

This highlights the importance of effective Fed communication. I noted earlier our attempts in the spring of 2013 to provide guidance about the potential timing and pace of tapering may have served to confuse market participants. Market participants seemed to conflate the prospective tapering of asset purchases with monetary policy tightening, and pulled forward their expectations about the likely timing of liftoff, thus raising their expected path for the federal funds rate. Since then, we have adjusted our approach with improved results. The actual tapering of the Fed's asset purchase program went smoothly and liftoff of our policy rate from the zero lower bound was in line with widely held market expectations. While the future path of policy is not on a pre-set course and must remain data dependent, we will strive to be similarly effective in our communications going forward.

As you know, we've taken a number of steps in recent years to increase transparency and improve our communications. This includes regular press conferences by the Fed chair following FOMC meetings; the publishing of growth, inflation, unemployment and federal funds rate projections by FOMC participants; a concerted attempt to lay out the guideposts that the FOMC will look at to assess progress toward our mandate; and an equally concerted attempt to lay out how our various policy tools—such as interest on reserves, overnight reverse repurchase (ON RRP) operations and reinvestment of principal payments from our asset holdings – will be used to pursue our objectives.

We are also working to be better stewards in safeguarding financial stability. Simply put, we failed to act early enough and decisively enough to stem the credit excesses that spawned the financial crisis and Great Recession. The U.S. was not alone in this shortcoming, but, given our position in the global financial system, we should have done better. We've taken important steps through new legislative mandates and a broader effort to rethink our regulatory and supervisory framework. In particular, systemically important banking organizations must now hold capital and liquidity buffers that are better aligned with their risk profiles. Many other changes have also been implemented, such as the central clearing of standardized over-the-counter (OTC) derivatives contracts, which should help make the global financial system more resilient and robust.

While these efforts remain a work in progress, I think they will reduce the risk of repeating the mistakes of the past decade, and enable us to take a more proactive stance toward addressing potential future vulnerabilities. Of course, we at the Fed are not alone here. Since the financial crisis, central banks worldwide have been engaged in a broad rethinking of how better to fulfill their mandates.

Let me close with a final thought. Adam Smith in the *Wealth of Nations* introduced the concept of the "invisible hand." Smith argued that individuals acting in their self-interest can collectively promote the public interest. This concept, I believe, also often applies to international monetary policy.[2] The biggest problems that countries create for others often stem from getting policy wrong domestically. Recession or instability at home is often quickly exported abroad. Equally important, growth and stability abroad makes it easier to set policy at home. Central banks, therefore, by individually acting on their domestic economy mandates, can collectively promote the global economy.

Thank you for your kind attention.

---

[2] There are important exceptions of course. Two noteworthy exceptions include "beggar-thy-neighbor" policies in which countries engage in unilateral competitive currency devaluation and trade protectionism.