Economic Performance: Sound Cyclically but Longer–Run Concerns

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Economic growth since the deep recession of 2008-2009 has been modest but balanced, and momentum is now building. The outlook for sustained cyclical growth is favorable. So far this expansion, the pace of growth has been dampened by real and financial adjustments following the unsustainable debt and housing bubbles, along with harmful economic and regulatory policies. Not surprisingly, the Fed's unprecedented monetary stimulus has been largely ineffective in addressing the real, nonmonetary constraints. As these post-crisis adjustments conclude, economic performance will strengthen in 2015-2016, supported by the Fed's aggressive monetary accommodation and lower energy prices. The oil price-related decline in inflation will be temporary and is very positive for the economy. Fears that inflation is too low are unwarranted. The appreciating US dollar reflects relative US economic strength and central bank monetary policy divergences; while it will slow exports, it benefits US consumers and domestic demand. History indicates clearly that once recoveries gain traction, Fed interest rate increases do not harm the economy and actually improve the balance of economic and financial performance and extend expansion. Challenges remain, however. Business capital formation has been disappointing, while insufficient labor skills are a drag on productivity and wage gains and underlie structural problems. Reforms are needed to lift long-run growth.

Post-crises adjustments and economic performance. Post-crisis US economic performance has behaved strikingly similarly to international experiences of slow recoveries and sustained high unemployment following financial and housing crises. Nominal GDP has grown comfortably faster than real potential growth (Chart 1), but it has failed to accelerate above 4 percent. This moderate growth in nominal spending has resulted in low inflation and wage increases. The primary result of the Fed's efforts to generate faster economic activity and more jobs with more and more monetary stimulus has been historically low interest rates, rising asset prices and financial distortions.

Real consumption growth has been moderately slower than during prior expansions, dragged down by weak consumption of services (Chart 2). This slower-than-normal growth in consumption reflects post-crisis household balance sheet adjustments, including deleveraging and a higher rate of personal saving. The slow growth of consumption of services while consumption of goods has grown similarly to most expansions likely reflects, in part, extremely low interest rates and falling relative prices of goods relative to services.

Business investment has increased as a percent of GDP in a fairly typical cyclical pattern (Chart 3), but its rate of growth has been disappointing in light of the very low costs of capital and record profits and cash flows. This shortfall in capital spending reflects to some degree government policies that are barriers to expansion—the highly inefficient and distorting corporate tax system, mounting regulations that add to operating costs, higher business health care costs and related uncertainties. The policy environment has a significant influence business decisions. The rising costs of complying with economic and regulatory policies and concerns about the trend in future policies dampen business expectations.

Despite these inhibitions, final sales to private domestic purchasers have increased at a 3 percent average rate in the last five years and 3.3 percent in the last year (Chart 4). At the same time, the trade deficit has remained largely unchanged—real net exports hover around 2.9 percent of GDP--in contrast to its typical cyclical widening. This reflects primarily increasing exports and fewer imports of oil and petroleum products, despite the government's ban against exporting crude oil (except to Canada) and its lingering (but slowly diminishing) inhibitions against natural gas exports.

Compared to prior expansions, the two biggest drags on GDP growth have been housing activity and the government sectors. Following the earlier collapse in housing, its recovery has been modest, despite extremely low rates on conventional mortgages, healthy gains in employment and a rapid decline in the unemployment rate. As a result, real residential investment is only 3.1 percent of GDP, half of its peak share of 6.2 percent in 2005Q3 and way below its historic average (Chart 5). One big inhibiting factor has been tight mortgage credit, which stems from misguided government policies. New regulatory burdens, government lawsuits and large settlements from mortgage providers and threats by the government GSEs to "put back" purchased mortgage pools that go bad (underperform) have harmed and increased the costs of mortgage origination and servicing. Not surprisingly, the Fed's efforts to depress conventional mortgage rates have not offset these harmful government policies. And recent initiatives of Fannie Mae, Freddie Mac and the FHA to ease credit standards for lower income households primarily encourage bad lending practices that contributed to the housing finance bubble and do not address the current bottlenecks in the mortgage market.

Government consumption and investment—that portion of government spending directly counted in GDP—has fallen 6.3 percent cumulatively during the expansion, reflecting cutbacks in Federal defense and state and local government operations and investments (Chart 6). Reducing the government's direct absorption of national resources frees up resources for faster private sector growth, but so far, that shift has not unfolded. Real Federal defense consumption and investment has been reduced 13 percent in the last five years and pending legislation points toward future increases. At the state and local levels, vastly improved finances are now supporting increases in spending on operations and infrastructure.

The failure of nominal GDP to accelerate has been disappointing, but key indicators suggest that the post-crisis adjustments are concluding and stronger growth is unfolding. Household balance sheets have repaired significantly. The ratio of household debt-to-disposable personal income has retraced half of its bubble-related rise (Chart 7) and debt service costs have fallen to record lows relative to disposable income. Household net worth has risen to an all-time high. Businesses are strong and bank lending and quality have largely returned to normal.

The household deleveraging process has ended and consumer borrowing is rising. In the last year, non-revolving loans (auto and student loans) have risen 8.3 percent, and revolving loans (credit cards) have risen 3.2 percent (Chart 8). Commercial and industrial loans have risen 13.3 percent and corporate bond issuance has been strong (Chart 9). Bank capital ratios have increased significantly, and delinquencies on consumer and business loans have fallen to all-time lows (Chart 10).

Real disposable personal income has risen 4.2 percent in the last year, reflecting 2.4 percent growth in employment (2.8 percent in the private sector), a robust 3.5 percent increase in aggregate hours worked (Chart 11) and modest wage increases. The unemployment rate has fallen very close to its natural rate (Chart 12). The lower energy prices are a big plus.

The decline in oil prices stems largely from the dramatic increase in US supply of oil/shale and as such is a positive supply shock for the US economy. It is boosting real purchasing power and lowering business operating costs, raising the share of nominal GDP that is real while temporarily lowering inflation. This will lift real profits and wages and contribute to strong financial market performance—largely the opposite impacts (but to a lesser degree) as the two negative oil price shocks of the 1970s. While the lower oil prices stimulate like a tax cut, they reduce rather than raise government deficits. They also lower operating costs of municipal and state governments. (Note that the tripling of oil prices during 2002-2007 did not sidetrack the economic expansion because the higher prices were demand driven and were not a supply shock.)

The stronger US dollar depresses exports and will widen the net export deficit; but by reducing prices of imports, it increases the purchasing power of consumers and will lift domestic demand. Consumption constitutes 68 percent of GDP, far larger than the 13 percent share of exports. Moreover, most of the US's largest trading partners—including Europe, Japan, China and India—benefit significantly from the lower oil prices. In particular, European economic performance is improving and its growth prospects have brightened. Improving global economic performance will support demand for US products even as the stronger US dollar raises US unit labor costs relative to foreign trading partners.

The timing of the positive economic impact of the lower oil prices is uncertain, but delayed responses seem likely, suggesting stronger second half growth. In recent months, as lower inflation has significantly boosted real disposable income, real consumption has increased, but not as fast, as households have raised their rates of saving while constraining spending. Consistent with Friedman's permanent income hypothesis, consumers have been tentative in spending their windfalls, waiting to see if the energy price declines are permanent. If energy prices stay low, which seems likely, the jump in real purchasing power will strengthen consumption. Real GDP is projected to grow faster than 3 percent in 2015, exceeding the FOMC's forecast.

The plunging oil prices have quickly depressed inflation, but that effect is strictly temporary. Excluding food and energy, core inflation has drifted modestly lower, as businesses have reduced product prices modestly in response to lower operating costs. However, this impact should be limited, as stronger demand for non-energy goods and services will support their prices. With the economy strengthening and labor markets tightening, inflation and wages are projected to rise above 2 percent.

Amid low inflation, the relative prices of various goods and services have changed significantly. The PCE deflator for services, which reflects prices of two-thirds of consumption, has been rising fairly consistently between 2.0 percent and 2.2 percent for the last three years (Chart 13). In contrast, the PCE deflator for durable goods has fallen 2.8 percent in the last year and has declined nearly 2 percent per year for the last 20 years. Thus, since 20 years ago, services prices have risen 64 percent while durable goods prices have fallen 32 percent (Chart 14). This reflects technological advances that have reduced prices and improved the quality of durable goods. Meanwhile, although the PCE deflator for nondurable goods has increased at about the same average long-run rate as the total PCE deflator, it has been much more volatile, reflecting large swings in energy and food prices. The PCE deflator for nondurable goods is now declining sharply, pushed down by energy prices. Such shifts in relative prices reflect changes in supply and demand for different goods and services. The Fed should gear monetary policy to achieve its long-run inflation target and not respond to changes in relative prices.

Economic performance: sound cyclically but longer-run concerns. In a cyclical sense, the economy is on sound footing. Although the economy is in its sixth year of expansion, a wide array of indicators show none of the troublesome late-stage excesses or imbalances that have led to prior recessions. The capital stock is low relative to output and labor inputs are appropriate. Business inventories are low. US unit labor costs are below those in most industrialized nations and are increasing modestly. Business profits and cash flows are strong. Excess housing inventories have been reduced. These indicators point toward sustained expansion.

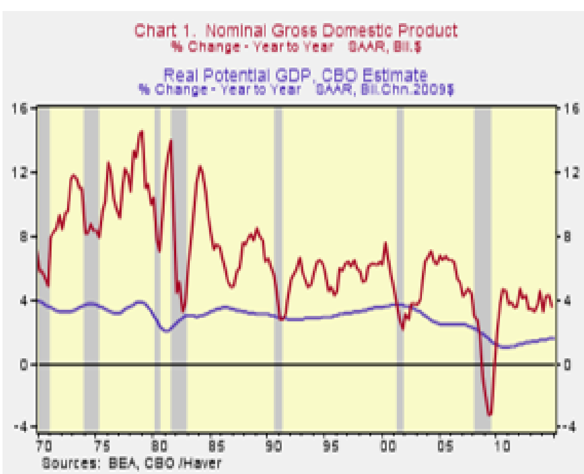
However, troublesome trends are apparent. Most notably, labor productivity has grown more slowly that during prior expansions. This has undercut support for real wage increases and generates concerns about the robustness of the economy and future sustainable economic growth. The low productivity gains are seemingly inconsistent with widespread anecdotal evidence of technological innovations and improved efficiencies in production processes, along with the record-breaking corporate profits.

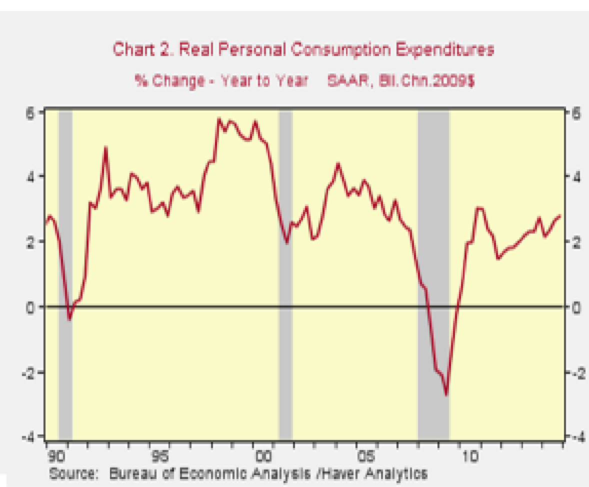
Some portion of the labor productivity shortfall is attributable to the outsized gains in aggregate hours worked following their collapse during the deep recession, and there may be measurement issues in capital spending and GDP. Nevertheless, the weak productivity gains are troubling and reflect to some extent the weakness in capital spending.

As noted above, this stems in part from government policies that deter business expansion and healthier growth. Some key reforms that would enhance sustainable growth are seemingly obvious. Unfortunately, they are ensnarled in short-sighted politics: corporate tax reform (which is favored by leaders of both political parties), energy reform (particularly allowing exports of crude oil and expediting exports of natural gas) and programmatic changes to key entitlement programs that would have no impact for years to come and fully protect current older workers and retirees, while addressing the government's massive long-run unfunded liabilities, to name a few. Until these issues are addressed, concerns about long-run growth will persist.

Fed rate hikes and economic growth. This expansion has shown that economic performance is influenced by a lot more things other than the Fed's monetary policy. This implies that the Fed should not push monetary policy beyond its natural scope. The current negative real funds rate is inconsistent with solid economic growth and modest inflation, and its distortions and risks far outweigh its benefits. The debate about when the Fed should raise rates and normalize monetary policy, which the Fed fuels through its policy statements and speeches by FOMC members, has gone on too long and seemingly misses lessons from recent history. Economic growth will be sustained even as the Fed begins hiking rates. During prior economic expansions, when the Fed raised rates--even during far earlier recovery stages than the present, and from already positive real rates--economic growth continued and subsequently strengthened. This observation should not come as a surprise. Hiking rates as a reflection of the rise in the natural rate associated with strengthening economic expansion would simply maintain monetary accommodation and would not constrain economic growth. That is particularly true now with $2.7 trillion of excess reserves and extraordinarily low bond yields. Note also that the US dollar was strengthening before, during and after the Fed's aggressive 1994 rate hikes, and US economic performance improved.

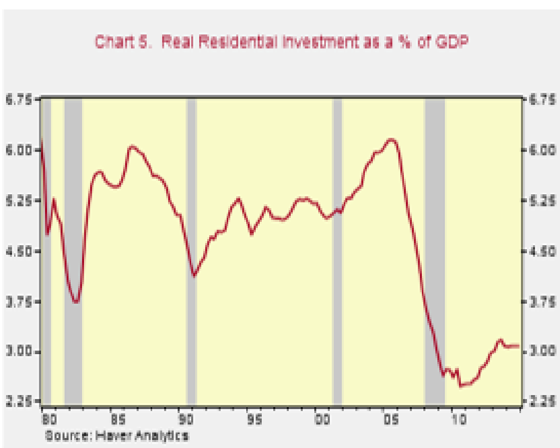
Nominal GDP growth above real potential growth; Consumption growing moderately

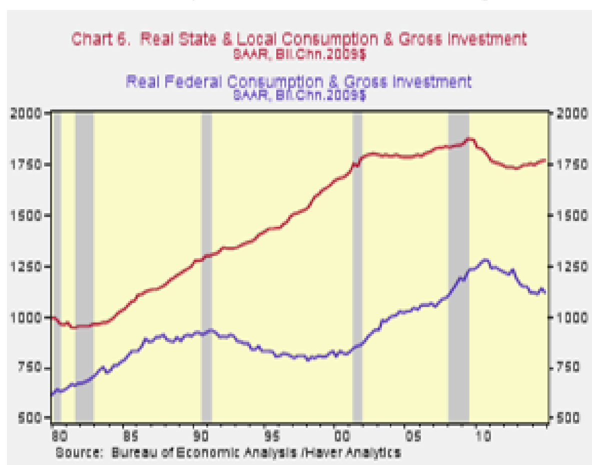




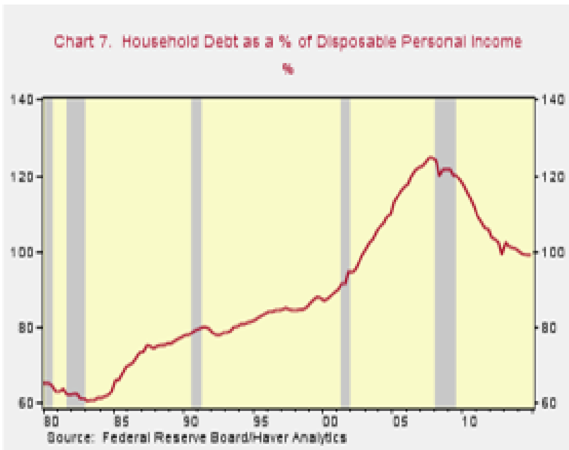
Business fixed investment growth moderate; domestic final sales to domestic purchasers solid

Residential investment recovery slow; government consumption and purchases lag

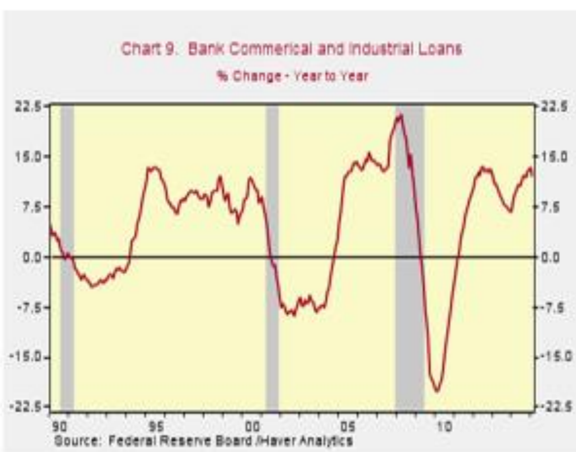


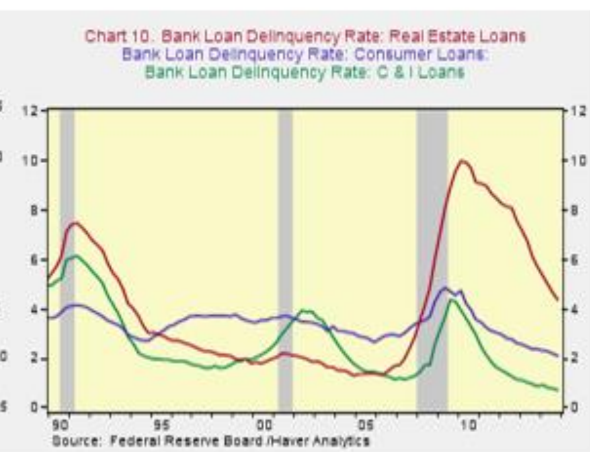


Household deleveraging concludes and consumer credit resumes healthy growth

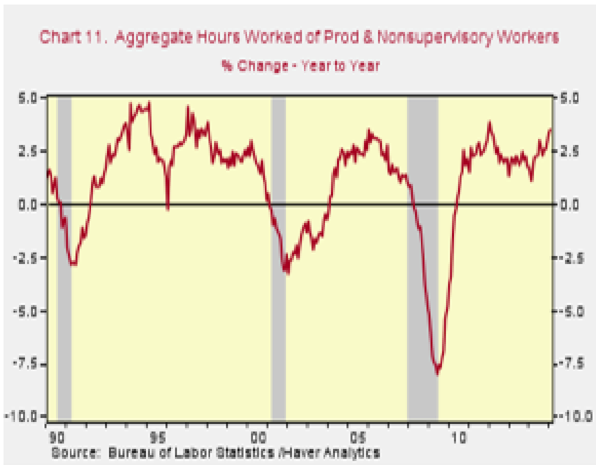


Commercial and industrial loan growth robust; credit quality strong





Aggregate hours worked growing rapidly, unemployment rate close to its natural rate



Wide divergences in PCE deflators highlight significant changes in relative prices