SPEECHES

Gauging Current Economic Momentum

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- Atlanta Fed President and CEO Dennis Lockhart, in an August 16, 2016, speech to the Rotary Club of Knoxville, Tennessee, discusses the national economy's underlying momentum and his economic outlook.
- Lockhart points to real final sales, a subset of GDP, for a more consistent picture of economic momentum than GDP. Real final sales rose at an annualized rate of 2.4 percent in the second quarter.
- Lockhart is holding to an outlook of moderate growth through 2017. His baseline forecast calls for achievement of the Fed's core monetary policy objectives—full employment and price stability—over the next year and a half.
- Lockhart assumes continuing healthy consumer activity and a modest acceleration in business investment.
- Lockhart will be watching the incoming data closely for confirmation that his outlook remains valid.

In late July, the Bureau of Economic Analysis released its first estimate of second-quarter growth of gross domestic product (GDP). Growth in the quarter was estimated at 1.2 percent annualized. The number was below our expectations at the Federal Reserve Bank of Atlanta and below the predictions of many others. The report has been treated as a downer. I gave an interview on August 2 and got the question, "What do you make of the *dismal* GDP report?" It's not surprising a GDP report so much below expectations evoked strong reactions.

When the history of the post-recession economic expansion is written, it will be described as a long period of relatively slow growth. Through mid-2015, GDP growth averaged a little over 2 percent. Over the last year, GDP growth has averaged just 1.2 percent. Over the first half of 2016, GDP growth has averaged just 1.0 percent at an annual rate. At face value, it might appear that economic momentum is decelerating.

At these low numbers, an apparent decelerating pace of growth would not seem compatible with policymakers' thinking about raising interest rates. Yet I, as one Fed policymaker, am not prepared to rule out at least one rate hike before year's end.

Today I will examine the national economy's underlying momentum by decomposing recent GDP growth. I will argue that the headline number overstates weakness last quarter. I'll draw attention to *real final sales*, a subset of GDP, as a better indication of economic momentum. Looked at through the lens of real final sales, the report was not so disappointing and is consistent with our experience over much of the recovery that began seven years ago in the summer of 2009.

I'll also lay out my baseline outlook for the rest of the year and next year, and I'll discuss the key risks I perceive around that outlook. As always, I will be presenting my individual views. I'm not speaking for the Federal Reserve, or for the Federal Open Market Committee, the FOMC.

Growth over the recovery
Let me start by providing some historical context for our current economy. As I said, from the summer of 2009 up to mid-year last year, official readings of growth of economic output had averaged a little over 2 percent.

In speeches a couple of years back, I was arguing that although the U.S. economy seemed caught "in a 2 percent growth world," the economy would shortly vault into a 3 percent world as various headwinds abated. That has not happened.

In my official forecasts submitted quarterly as part of the FOMC process, and in my public comments, I have marked down my expectations of what is sufficient growth. I've come to the view that GDP growth at around 2 percent in today's economy is sufficient to achieve the Fed's monetary policy objectives of full employment and price stability in a reasonable timeframe.

We've seen pretty strong employment performance despite the weaker-than-expected growth of real GDP. From the peak of unemployment in October 2009, the economy has added more than 14 million jobs, and the official unemployment rate has declined to 4.9 percent according to the last report of the Bureau of Labor Statistics for July. In the past 12 months alone, the economy has added two and a half million jobs.

While jobs growth has been impressive, wage growth has been modest over the full period of recovery. Only recently have we begun to detect broad-based wage pressures. Still, these wage pressures may be signs we're approaching full employment. Wage inflation can also be a factor in the firming of broad inflation we desire.

Recent growth story
Over seven-plus years of moderate growth, the mix of factors contributing or detracting from growth has not been constant. The immediate drivers of and drags on expansion have ebbed and flowed.

Let me take a moment and walk you through the moving parts, so to speak, of GDP accounting. Estimates of gross domestic product measure total output. The biggest elements of total output are goods and services produced and consumed in a given period, the net change in private-sector inventories (inventories produced in the current period to be consumed later, less those produced earlier and consumed in the current period), the net of exports (output produced here but consumed abroad) and imports (output produced abroad but consumed here), and residential and business fixed investment. In addition, roughly a fifth of our economy is government services and investment.

Early in the recovery, growth was driven by a substantial ramp-up in business investment. One way to understand this is as a catching up of investment deferred during the recession. Business investment included both fixed investment—that is, capital expenditures—and inventory. Consumer activity was fairly weak, except for autos. Government spending was a drag because of shrinking state and local budgets.

Later in the recovery, investment trailed off and has recently become a drag on growth. Consumption has strengthened as household wealth and incomes have recovered.

This is, in good part, the picture today. Recent economic momentum has been consumer-driven. Inventory drawdown has been a drag on growth over the last five quarters, a rather long period. Exports relative to imports remain a drag. Government has moved from a drag on growth to a modest contributor to growth. And very importantly, business fixed investment—capital spending by the private sector—continues to be weak. Yes, the drop in energy prices has suppressed oil and gas structures investment, but this is just part of the story. Business investment overall has been on a slowing trend since 2012 and has actually declined over the past year.

Business fixed investment

Weakness in business investment is an unusual phenomenon for an expansion. There are a number of plausible explanations. I will cite some that my team has heard from our contacts across the Southeast.

Our business contacts mention heightened uncertainty—both global and domestic. This has been a recurrent theme for some time.

Sometimes our contacts cite specific events on the horizon. An example would be the recent Brexit referendum in the United Kingdom. Recently I've heard mention of political uncertainty here in the United States associated with the upcoming election. I don't have direct causal evidence linking weak business investment and current political uncertainty, but it's possible the election is a factor—maybe not a primary factor—but a factor nonetheless affecting investment decision making.

Recent research on the effects of uncertainty on economies suggests that even discrete spikes in uncertainty can have prolonged negative impacts on investment activity. Given the seeming frequency of risk events, the picture may just be one of decision makers never getting out of wait-and-see mode.

Specific concerns like Brexit have been elements of a general atmosphere of heightened uncertainty fueled by—for example—political dysfunction, distressing fiscal scenarios, and worldwide economic and financial developments. Starting with the FOMC's January meeting this year, the Committee has noted in post-meeting statements that risks associated with "global economic and financial developments" bear close watching.

A second frequently cited explanation for a cautious approach to capital investment is businesses projecting relatively weak demand going forward. Firms continue to be cautious about an assumption of organic growth. In a number of recent conversations, companies mentioned mergers and acquisitions as their preferred growth strategy because they are not counting on organic growth.

A third and related explanation is the lack of direct pricing power and continuing pressure on margins and profits. In this vein, some firms have mentioned excess capacity as well as foreign-sourced product competition responding to global capacity and the stronger dollar.

Accurately measuring capacity utilization in a large, diverse economy is a challenge. The most familiar monthly measure of capacity utilization—currently calculated to be around 75 percent—is pretty narrow in scope. It is derived from a survey of manufacturing, mining, and utilities firms—hardly a comprehensive perspective in a services-dominated economy. Nonetheless, the figures are interesting. Over the past 30 years, the highs for capacity utilization metrics were around 85 percent. These came in the mid-1990s, a period of strong investment growth. In the Great Recession, capacity utilization hit lows in the mid-60 percent area. As I said, today these measures of capacity utilization are around 75 percent, and industrial capacity is barely growing. I infer that businesspeople, in the industrial sector at least, have some justification for deferring capital spending on excess capacity grounds.

Because my staff and I consider some renewal of business fixed investment to be pivotal, my Atlanta Fed colleagues have taken every opportunity in recent months to ask about capital spending plans and attitudes. Current capital spending is depicted mostly as replacement, productivity-improvement-oriented, or cost-takeout focused. While most of our conversations evinced some longer-term optimism about potential for expansionary, capacity-building investment, we heard little that would suggest a near-term reversal of the weak trend.

Baseline outlook

I have two key assumptions in my outlook for the second half of 2016 and for 2017. One assumption is continuing healthy consumer activity. I'm not counting on consumption growth at the brisk pace of more than 4 percent (annual rate) in the second quarter. Consumption growth will probably settle back to something closer to the growth of incomes. Last Friday, we received a retail sales report for July. It suggested a slowdown of consumer spending compared to the second quarter. I'm interpreting that slowdown as expected moderation, not a cause for alarm.

A second assumption is a modest acceleration in business investment. I acknowledge there is tension between an assumption of an upswing in business investment and what people in the business community are saying. For that reason, I'll be watching carefully for signs of a pickup in capital expenditures.

I'm expecting decision makers' caution regarding capital expenditures to fade, to an extent, as sustained growth of consumer activity proves out over the coming quarters. My staff has performed statistical analysis that suggests that increases in consumer spending tend to lead acceleration of business investment.

I would argue that most of the fundamentals underpinning growth of consumption are pretty solid. Household balance sheets have been repaired. Employment prospects appear reliable, and the number of employed workers is growing. Interest rates are low for many borrowers. Gasoline prices remain low. Personal incomes are rising, and, as I said earlier, wage growth is beginning to pick up. Consumer confidence remains high. At the same time, it appears that recent consumption was fueled, in part, by drawing down personal savings. It's unlikely this will last. In my opinion, consumption growth as strong as last quarter isn't required for continued expansion.

If you look beyond the troubling headline GDP growth number for the second quarter and study *real final sales*, a more consistent picture of economic momentum emerges. "Real final sales" is GDP less inventory swings. The trend of real final sales is a good gauge of ongoing demand conditions. Real final sales rose at an annualized rate of 2.4 percent in the second quarter, more than a percentage point higher than the headline GDP growth number. Over the last year, growth of real final sales is 1.9 percent. Recent experience is consistent with results over the full seven-year period of expansion. Final sales growth has been fairly steady since 2009.

So, I'm holding to an outlook of moderate growth through 2017. Furthermore, my baseline forecast calls for achievement of the Fed's core monetary policy objectives over the next year and a half.

Job gains cited in the most recent employment report (for July) were impressive, and gains were broad-based across industries. Taken together with an unemployment rate of 4.9 percent and stronger wage growth, I think it is fair to say we are closing in on full employment.

Price stability is the companion objective of full employment in the Fed's dual mandate from Congress. Inflation has not yet accelerated to the Committee's target of a 2 percent run rate, but seems to be moving in a healthy direction. Recent price data hint at the firming of underlying price pressures. I'm reasonably comfortable with a forecast of reaching 2 percent by year-end 2017.

Certainly, there are risks to this hopeful scenario. For example, the U.S. economy is not completely insulated from weakness elsewhere. Judging from recent actions of foreign central banks, major economies continue to combat very weak conditions that may worsen. That said, as I explained earlier, the risk that concerns me most is the risk that an upswing in business investment fails to materialize.

So, to sum up, I caution against overreacting to the second-quarter headline growth number. Early indications of third-quarter GDP growth suggest a rebound. I don't believe momentum has stalled. I remain confident about prospects in the second half of 2016 and 2017. I will be watching the incoming data closely for confirmation that the outlook I've presented here today remains valid. I'm not locked in to any policy position at this stage, but if my confidence in the economy proves to be justified, I think at least one increase of the policy rate could be appropriate later this year.

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