

A Discussion of Economic Conditions and Federal Reserve Policy

Remarks before the University of Houston



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The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

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Thank you, President Khator for that very warm introduction. Renu Khator is a fantastic president of the University of Houston and chancellor of the University of Houston System. You may know that she also chairs the board of directors of the Federal Reserve Bank of Dallas. This is an important job, and we appreciate the contributions she makes to the Dallas Fed and the Federal Reserve System. President Khator, thank you for your service and for your leadership.

It is an honor for me to be here today. Growing up in Kansas, I frequently traveled throughout Texas with my father, who was a jewelry salesman. Through these visits, I learned firsthand the challenges of running a small jewelry store. I learned about the importance of access to credit in order to carry inventory. I learned about the key role that community banks play in helping small businesses get started and flourish.

In my professional career, I visited Houston regularly while working as a banker and, later, as a professor. Things here have changed a lot over all these years—but I have always been impressed by the entrepreneurial spirit and can-do attitude in this city and in this state. It is a pleasure for me to be in Houston.

I have been president of the Dallas Fed for about 2 1/2 months now and have represented the Eleventh District in two Federal Open Market Committee (FOMC) meetings—in September and October. People often ask me if there have been any surprises. The answer is yes—and they have all been positive.

First, I have been enormously impressed with the quality, rigor and dedication of the Federal Reserve staff who work in the Eleventh District and throughout the entire Federal Reserve System. They are truly outstanding. They are focused on the mission of serving the people of this district and the nation. If you could see what I see every day, you would be enormously impressed.

Second, I have been gratified by the warm welcome and hospitality of the people of the Eleventh District, which (as you probably know) includes Texas, southern New Mexico and northern Louisiana. They have been welcoming and have gone out of their way to help me integrate into the community and get up to speed so I can effectively do my job. Since I started this job, I have spent a substantial amount of time meeting with business

and community leaders, as well as a variety of other people in the district, and talking with Federal Reserve staff to get their advice and perspectives. Through these interactions, I have learned that an openness and a willingness to embrace newcomers set Texas apart—I believe these are characteristics that have helped to make this state so successful.

So now, I'm proud to say that, while I wasn't born in Texas, I got here as soon as I could!

As you may know, I worked in the global markets for 23 years and then taught leadership at Harvard University for 10 years. I lived in Asia during five of those years (in the early 1990s). Over the course of my career as an executive, I've run several global businesses, seen booms and busts in the markets, and certainly made my share of mistakes. As a professor, I've had a chance to work with a broad range of leaders across sectors and countries—and learned a lot about what leadership practices work and about those practices that usually do not. I bring these lessons and experiences to my new role as president of the Dallas Fed and a participant in the FOMC.

With this as background, I'd like to discuss today the economic conditions in the Eleventh District, the nation and the world. Then I'll discuss the implications of all this for U.S. monetary policy. Of course, the views I express today are my own and are not necessarily shared by my Federal Reserve colleagues.

Eleventh District: Discussion of Energy

Let me start with a discussion of the energy industry because of its importance to the Eleventh District and its broader impact on the national and global economies.

Percentage-wise, the state's energy sector is smaller than it was in the mid-1980s. However, it is still a major driver of the Texas economy. The industry in Texas accounts for roughly 3 percent of employment but is responsible for 14 percent of the state's gross domestic product (GDP).¹ This industry has transformed itself over the past two decades, which is a credit to many people in this great city.

The Department of Energy currently estimates that the world production of crude oil exceeds consumption by about 1.6 million barrels per day.² In the 34 member countries of the OECD (Organization for Economic Cooperation and Development), excess oil inventories now stand at record levels.

It is our view that it will not be until late 2016 or early 2017 before inventories stabilize and daily production and consumption reach some reasonable degree of balance. Only

after that point should demand be sufficient to begin working down this high level of inventory.

While several factors will influence this balancing process, certainly supply will need to be further reduced among higher-cost producers. Much of this reduction is already occurring in the United States—particularly among companies that produce oil from shale formations. We have already seen dramatic rig count declines as producers change their oil-price outlook to “lower for longer” and cut back on the amount of capital allocated to drilling.

Several additional factors will likely affect the balance between global production and consumption of crude oil. These include the level of demand in China as well as consumer demand in the U.S., and additional production coming online in Iran and Libya. Of course, geopolitical developments in the Middle East could impact production levels as well.

As market participants work to get a grip on the speed of this balancing process, we expect to see significant price swings and volatility. We also expect to see more bankruptcies, mergers and restructurings in the energy industry. Unfortunately, much of this pain will be felt in the U.S. because we have a large concentration of high-cost production coming from shale. Houston is certainly feeling some of these negative repercussions.

On the bright side, lower energy prices help U.S. consumers. However, the reduction in drilling continues to negatively impact growth and employment in the Eleventh District.

Discussion of Economic Conditions in the District

The energy situation and a stronger dollar have created headwinds in the district. Despite this, the Texas economy is expanding—Texas employment growth, which has typically been faster than that of the nation, has slipped to 1.3 percent year to date through September, compared with 1.7 percent for the U.S. as a whole. We expect Texas job growth to finish this year at 1.2 percent, much lower than the 3.6 percent growth the state experienced in 2014.

The Dallas Fed’s Texas Business Outlook Surveys (TBOS) and employment data point to continued weakness in the state’s manufacturing sector but solid growth in the service sector. The service sector has kept the Texas economy out of recession this year—with particular strength in the health care and leisure-and-hospitality industries.

Even with tepid job growth, the unemployment rate in Texas has held steady this year at approximately 4.2 percent—well below the national rate of 5.0 percent (it's 4.4 percent in Houston, 3.7 percent in Dallas, 3.6 percent in San Antonio, and 3.2 percent in Austin). The statewide rate of 4.2 percent matches the 2007 prerecession cyclical low. This resilience is due to the state's diversified economy as well as continued significant expansion of the petrochemical industry along the Gulf Coast—spurred by low prices for natural gas (the primary feedstock).

We continue to see labor shortages in Texas in construction, machinery and food manufacturing, nursing, truck driving, retail and restaurants. Texas home prices are rising at a rapid pace—up 6.1 percent year over year in September.³ Home inventories remain tight at 2 to 4 months in most of the state's major markets.

It's worth emphasizing that the migration of people and firms has been a key underpinning of the Texas economy. Over the past several years, many foreign and domestic companies have moved their operations to the state—and many others are considering moving to Texas. Since 2000, the average rate of population growth has been almost a full 1 percentage point higher in Texas than in the U.S. as a whole. I would expect this trend to continue over the next several years.

While facing challenges, the Texas economy is proving to be highly resilient, and I'm very optimistic about the state's future.

National Economy

GDP

U.S. GDP growth slowed to approximately 2 percent in the third quarter versus 2.3 percent over the first half of this year.⁴ The Commerce Department reported a slowing of inventory accumulation during the quarter. This deceleration in inventory investment was enough to subtract roughly 0.9 percentage points of growth from the U.S. economy. In the face of uncertainty about foreign demand, along with a strengthening U.S. dollar, it appears that U.S. firms decided to cut back their stock building in the quarter in order to avoid excessive inventory accumulation.

However, in this same quarter, the Commerce Department estimates that real final demand in the U.S. increased at a 2.9 percent annual rate—slightly better than the 2.7 percent rate recorded over the first half of the year. Most of the growth can be attributed to an increase in domestic consumer demand as well as to some gains in business fixed investment, residential investment and government purchases.

The U.S. economy maintained its forward momentum in the third quarter, largely because of strength in the service-providing sector, which represents about 80 percent of the U.S. economy.

At this point, our economic team at the Dallas Fed forecasts that U.S. GDP growth will average between 2 and 2.5 percent through the end of 2016. While this is sluggish growth compared with past expansions, given demographic trends, we believe it should be sufficient to continue to drive down the unemployment rate.

Unemployment

As I mentioned earlier, the U.S. unemployment rate has fallen to 5.0 percent—a rate that is near most estimates of full employment.

In 2015, the U.S. has added on average 206,000 nonfarm jobs per month. In addition, the pace of employment growth accelerated in October to 271,000 jobs after decelerating in August and September. This monthly rate of job growth has been strong enough to drive down the headline unemployment rate by 0.6 percentage points since the start of the year.

At the Dallas Fed, we estimate that the breakeven number of new jobs necessary to keep the unemployment rate steady likely ranges between 100,000 and 150,000 per month—depending on assumptions regarding the labor force participation rate as well as estimates of the relationship between the number of jobs in the economy and the number of people who actually hold jobs (these measures are not identical because some people work multiple jobs).

At this point, the question is: How much “slack” remains in the economy with the unemployment rate this low? My own view is that excess capacity needs to be increasingly viewed in a global context—particularly in assessing the level of unemployment that is consistent with price stability. This is a critical point that has emerged as the global economy has become increasingly interconnected. It means that overcapacity in non-U.S. economies must be considered along with domestic labor slack in assessing the implications of a given U.S. unemployment rate.

In order to assess the level of domestic labor market slack, we closely monitor various measures beyond the headline unemployment rate. In particular, we closely track the transition of workers from part time to full time as well as the number of would-be workers who are “discouraged” and have given up looking for a job.

For much of the current recovery, these broader utilization measures suggested that there was more labor slack than was implied by the headline unemployment rate. However,

particularly in the past two months, an increasing number of part-time workers have converted to full-time status—which suggests that we are making more progress toward reaching our full-employment objective.

Inflation

Inflation continues to run below the Fed’s 2 percent target. The headline year-over-year PCE (personal consumption expenditures) inflation reading for September was only 0.16 percent.⁵ This is a lower level of inflation than we are accustomed to. Much of this recent weakness is due to the near-term effects of lower energy and other commodity prices, with downward pressure also coming from slowing economic growth and overcapacity outside the U.S. and the impact of a stronger dollar on import prices.

Our economists particularly focus on the Dallas Fed’s Trimmed Mean PCE inflation reading, which strips out the most extreme monthly upside and downside price movements. We believe that the trimmed mean is a more useful guide to assessing the medium-term trend in headline inflation than is the conventional, ex-food-and-energy core inflation reading.

This Trimmed Mean PCE inflation measure has been running at approximately 1.7 percent year over year through September, and at a somewhat faster rate on a six-month basis.⁶ The stability of this Trimmed Mean PCE inflation measure, in the face of commodity price declines and falling import prices, gives us confidence that these influences will ultimately run their course. This confidence, in combination with anticipated further reductions in labor market slack, leads our Dallas Fed economists to forecast 1.8 percent inflation in 2016 and 2 percent inflation by year-end 2017.

This is an analysis (and a judgment) that we’ll be scrutinizing and revisiting over the coming weeks and months.

International Economy

Assessments of economic conditions outside the United States are critical because the world is becoming more and more interconnected. What happens in China, emerging markets and advanced economies around the world increasingly impacts the U.S. economy.

Our staff at the Dallas Fed estimates that second-quarter global GDP growth (excluding the U.S.) was the slowest since the second quarter of 2013. Advanced as well as emerging-market economies experienced slower yearly growth rates in the second quarter. The International Monetary Fund (IMF), in its latest World Economic Outlook, forecasts that this trend will likely continue for the remainder of this year and through the

end of 2016. Russia, Brazil and Venezuela are in outright recession. Advanced countries are experiencing only modest growth—with a forecast of 1.4 percent GDP growth for 2015.⁷ While economies such as China and India still exhibit relatively strong real output growth, their growth forecasts are being revised downward due to various headwinds.

Factors contributing to this uneven performance include overcapacity in various economies, higher levels of debt, falling commodity prices and exchange rate developments.

Let's focus more specifically on China. While the Chinese economy grew 6.9 percent year over year in the third quarter, according to official estimates, growth is clearly slowing. This slowing has been manifested in dramatic price swings in the Chinese stock market and in government actions to address key longer-term challenges.

Understanding China's slowdown is important because China is still the largest individual contributor to global growth.⁸ The effects of a slowdown in China will be felt in the United States as well as other countries. The IMF forecasts that 2016 Chinese GDP growth will slow to 6.3 percent.

At the Dallas Fed, we estimate that a 1 percentage-point decline in the Chinese GDP growth rate slows the U.S. GDP growth rate by about 0.2 percentage points due to direct and indirect third-country effects.

It is my own view that the primary economic challenges faced by China—manufacturing overcapacity, an aging population, higher levels of debt to GDP, and a structural transition to a more service-based economy—are all secular. That is, they are likely to play out over many years (versus months). As a result, the world will likely have to adjust to lower expected rates of Chinese growth.

Implications for Monetary Policy

Given these factors and the situation I have laid out, let me turn to a discussion of U.S. monetary policy and the decisions facing the FOMC.

The Fed has a dual mandate given to it by Congress—fostering full employment and price stability. Further, the Fed has set 2 percent as its longer-run target rate for inflation.

At this stage, it appears that we are well on our way to meeting our full-employment objective, although there is still some question as to the rate of unemployment that constitutes full employment in a more global world. As I mentioned earlier, a critical question I am focusing on is: What is the unemployment rate at which we have depleted

excess capacity in the labor force? This rate may be lower than we would have previously thought.

Inflation continues to run below our 2 percent long-run target. However, as the labor market tightens and certain transitory factors ultimately pass through the data, our economic team in Dallas still expects to see inflation gradually rising to 2 percent over the medium term.

Our economic team is continuing to consider how overcapacity, demographic trends, high degrees of leverage in some sectors and other secular issues in countries outside the U.S. (particularly China) might adversely affect GDP, unemployment and inflation within the U.S.

In light of all these factors, it will likely be appropriate that U.S. monetary policy remain accommodative for some time. Moreover, a lower-than-usual federal funds rate may well be needed to achieve any given desired level of accommodation. Accordingly, it is probable that the return to “normal” interest rates will be gradual. As a business manager or as an investor, I think these are key messages I would be taking from our FOMC statements.

However, accommodative policy does not necessarily mean a zero fed funds rate. There are various costs to maintaining a zero fed funds rate for too long—particularly in terms of potential distortions in investment and business decisions. These distortions can create imbalances in investments, inventory and hiring decisions that may later need to be (painfully) unwound when policy normalizes. My experience is that these imbalances are sometimes tough to see in real time but often relatively easier to recognize in hindsight.

In thinking about these potential imbalances, we’re sensitive to the fact that monetary policy affects the economy with a lag.

These are all issues that will have to be assessed and reassessed as the economic outlook unfolds. In my view, the FOMC—in the previous two meetings—has been prudent in waiting for more data before taking policy action.

Thank you for the opportunity to speak today. I look forward to getting to know you better in the months and years ahead. Now, I’d be happy to take your questions.

Notes

¹ Sources are as follows: employment—Bureau of Labor Statistics and Texas Workforce Commission, with seasonal and other adjustments by the Federal Reserve Bank of Dallas; GDP—Bureau of Economic Analysis.

² See “Short-Term Energy Outlook,” Energy Information Administration, October 2015.

³ Based on data from the Multiple Listing Service, with seasonal adjustments by the Federal Reserve Bank of Dallas.

⁴ The Commerce Department reported on Oct. 29, 2015, that U.S. GDP growth in the third quarter was 1.5 percent. However, inventory data released by the Census Bureau on Nov. 13, 2015, suggest that the drag on GDP growth from slower inventory accumulation was not as large as previously thought. Adjusting for this revision, we estimate third-quarter GDP growth was approximately 2 percent.

⁵ On Nov. 17, 2015, the Bureau of Labor Statistics released Consumer Price Index (CPI) data for October. They show that the non-seasonally adjusted headline CPI rose 0.2 percent on a 12-month basis, after being flat in September.

⁶ The 12-month change of the core CPI index (non-seasonally adjusted) held steady at 1.9 percent in October, based on data released by the Bureau of Labor Statistics on Nov. 17, 2015.

⁷ Real GDP in advanced economies (excluding the U.S.) will grow 1.4 percent in 2015, according to estimates by Federal Reserve Bank of Dallas economists.

⁸ China accounts for roughly 1.2 percentage points of the 3.1 percent year-over-year global growth expected in 2015, according to the IMF.