

Discussion of Economic Conditions and Implications for Monetary Policy

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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 for having me here today. I appreciate the opportunity to talk with you.

A little background: I have been president of the Dallas Fed since early September of 2015. Since that time, I have had the opportunity to meet with and get to know business and community leaders and talk with many other people throughout this district (which includes Texas, northern Louisiana and southern New Mexico). I have attended four Federal Open Market Committee (FOMC) meetings and developed good working relationships with the other Federal Reserve Bank presidents as well as with the Board of Governors.

I've been impressed with the quality of the people at the Fed and their unwavering commitment to serve the citizens of the nation. I have seen a high level of rigor, intensity and overall excellence in the Fed's work on monetary policy and supervision, as well as in the various other important functions it performs on behalf of the American people.

Since taking this role, I have developed a much greater appreciation for the complexity of the Fed's work in analyzing economic conditions and making decisions regarding monetary policy. I have learned that, in a rapidly changing world, there are seldom "no brainer" or easy decisions. This work requires an open mind, intellectual diligence and persistence, a willingness to work through complexity, and a desire to understand arguments and counterarguments. And yes, when appropriate, you have got to be able to change your mind and make balanced judgments in order to serve the nation.

One key aspect of the Fed is the vital role played by members of the private sector as well as community leaders in our work. On the Dallas Fed boards of directors, which include our branch boards in Houston, San Antonio and El Paso, we have business, community and nonprofit leaders with diverse geographic, cultural and functional backgrounds. They spend a substantial amount of time with us sharing valuable insights regarding economic trends and overall economic conditions.

In addition, hundreds of private sector businesses in our district regularly participate in our manufacturing, service sector, agricultural, energy and Beige Book surveys.¹ These surveys are an essential information source regarding conditions in our region. In addition to these activities, before every FOMC meeting, I speak with numerous industry leaders to discuss their insights regarding economic conditions in the district, the nation and the rest of the world. Our economic research and policy work is dramatically enhanced by the enormous contribution of time from

this diverse group of leaders. Their contributions are essential to our ability to make sound decisions for the country.

With that background, let me make a few comments on economic conditions in the district, the nation and the world. I will then comment on implications of these conditions for monetary policy.

The Eleventh District: Discussion of Energy

It is our view at the Dallas Fed that, in 2016, global energy production will exceed consumption by an average of approximately 1 million barrels per day.² By year-end, we believe that this excess will decline to approximately 500,000 barrels per day.³ We expect that global demand will grow by approximately 1.2 million barrels per day in 2016.⁴

OECD (Organization for Economic Cooperation and Development) inventories continue to increase and now stand at roughly 400 million barrels above the historical five-year average.⁵ These excess inventory levels will increase through 2016, and there is now some discussion in the industry about potential limits in storage capacity.

We estimate that the market will not find some degree of daily production/consumption balance until mid-2017 and, at that point, excess inventories will begin to decline. This forecast has been influenced over the past several months by the official return of Iran to the world oil markets, increased supply from OPEC nations, slower-than-expected supply declines from U.S. producers despite substantial cuts in drilling and capital spending, and slower-than-expected demand from emerging-market countries. This outlook would be meaningfully impacted by a change in OPEC production strategy.

Given these various factors, the ultimate timing of market production/consumption balance remains uncertain. In the meantime, we expect to see continued low prices and high levels of price volatility, as well as more bankruptcies, mergers and restructurings in the energy industry.

One by-product of lower oil prices is wider credit spreads in the high-yield market. Because corporate energy issuers comprise a material portion of high-yield issuance, and because high-yield debt is heavily held in mutual-fund (with daily liquidity obligations) and exchange-traded fund form, weakness in the energy sector has the potential to create increased levels of fund redemptions. This, in turn, can put pressure on funds to sell holdings more broadly in order to meet liquidity needs. This is a good example of the potential negative ripple effects that can come from persistent weakness in the energy sector.

Broad Economic Conditions in the Eleventh District

As has been the case for the past year, the Eleventh District is being adversely affected by low oil prices as well as the strength of the dollar. As a result of these challenges, Texas job growth slowed from 3.6 percent in 2014 to 1.5 percent in 2015, and Dallas Fed economists expect only

about 1 percent growth in 2016.⁶ Risks to this forecast are to the downside if oil stays at or below \$30 per barrel for an extended period.

While the nation's unemployment rate has declined since the beginning of 2015, the Texas unemployment rate increased from 4.4 percent at the beginning of the year to 4.6 percent at year-end.⁷ We expect the state unemployment rate to rise further in 2016 even as the national unemployment rate continues to fall.

In 2015, the Texas energy and manufacturing sectors lost jobs while the state's service sector showed steady, moderate growth.⁸ This recent economic performance has been bolstered by the diversified nature of the Texas economy. While Houston's growth has been brought to a halt by the energy downturn, Austin, Dallas and San Antonio have shown strong growth and continue to attract people and firms from around the country and the world.

The energy industry accounted for approximately 2 percent of Texas employment⁹ and approximately 10 percent of gross domestic product (GDP) in 2015,¹⁰ a good deal lower than in the 1980s, when that oil bust pushed the Texas economy into a major recession. While the downturn in the energy industry has created negative ripple effects in the state, the Texas economy has proven to be highly resilient. I expect this resiliency and underlying strength to continue as the negative impacts of energy begin to dissipate in the years ahead.

Economic Conditions in the Nation

Gross Domestic Product and Unemployment

The Commerce Department estimates that the U.S. economy grew 1.9 percent in 2015, and our economists expect a similar rate of growth in 2016.¹¹ This rate of GDP growth, while sluggish by historical standards, was sufficient to drive down the U.S. unemployment rate from 5.6 percent at the start of the year to approximately 5 percent by year-end, and to 4.9 percent in January.¹²

The service sector continues to be the primary driver of growth in the U.S. economy. In contrast, the manufacturing sector continues to struggle as a result of a strong dollar and continued weakness outside the U.S.

Our economists expect the unemployment rate to continue to decline in 2016, but at a slower pace. In addition to looking at the headline rate, we also track other measures that gauge the degree of slack in the labor market. In particular, we closely monitor the labor force participation rate, which is the share of the population that is either employed or actively looking for work. This share is currently 62.7 percent, which is approximately 3.5 percentage points below its prerecession level.¹³ Our Dallas Fed economists believe that over one-half of this decline is explained by aging-workforce demographics. We are also tracking measures of "discouraged" workers, who have given up looking for work, as well as estimates of the number of part-time workers who might convert to full time in a stronger job market.

My own view is 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 an increasingly globalized world, U.S. companies assess their employment decisions in a global context. As a result, I believe that the headline rate which constitutes “full employment” will likely be lower than the level to which we have historically been accustomed.

Inflation

Headline inflation readings continue to run below the 2 percent long-run objective set by the FOMC. A stronger dollar and lower oil prices are two key factors that are negatively impacting the rate of inflation.

At the Dallas Fed, we attempt to look past more transitory factors by focusing on the Trimmed Mean PCE (personal consumption expenditures) inflation rate, which excludes those items with the most extreme upward and downward monthly price movements. Since early 2014, the 12-month change in the trimmed mean ran between 1.6 and 1.7 percent. In January 2016, the 12-month rate ticked up to approximately 1.9 percent. The stability and trend of this measure are important to track as we consider inflation prospects over the medium term.

I will be closely watching these measures as well as the impact of anticipated further reductions in labor market slack in assessing the Fed’s progress toward meeting its 2 percent objective. I will also be monitoring the impact of key secular trends discussed later in this speech.

World Economic Conditions

Assessments of economic conditions outside the U.S. are critical because the world is becoming more and more interconnected. As a consequence, slowing growth in China and other emerging markets increasingly impacts the U.S. economy.

Our economists at the Dallas Fed have lowered their expectations for growth outside the U.S. In 2016, we expect global growth, excluding the U.S., to be approximately 2.7 percent. This includes negative growth in commodity-exposed countries such as Brazil, Russia and Venezuela as well as 7.4 percent GDP growth in India.¹⁴ This estimate of the non-U.S. growth rate comes with a high level of downside risk.

One particular concern is China, which is trying to manage high levels of industrial overcapacity, high levels of leverage, aging demographics, and decreasing levels of reserves (which they have used to manage their currency devaluations). China is also working to manage a longer-term transition from a manufacturing and export-driven economy to one that is more consumer and service-sector based.

The International Monetary Fund forecasts that China’s growth rate will slow to approximately 6.3 percent in 2016 from 6.9 percent in 2015. Whatever the actual number, it seems clear that the world will have to adjust to lower rates of Chinese growth in the years ahead. China’s economic

challenges have the potential to create negative spillovers that impact economic conditions in the U.S. as well as other economies.

Monetary Policy

As a businessperson, I am regularly reminded that it is important to be open to learning from and adapting to changing circumstances. It is important to avoid being rigid, closed minded, or ideological in my thinking. Asking the right questions is more important than having all the answers. With that preamble, let me discuss my views regarding monetary policy.

From January 1 through March 1 this year, the Standard & Poor's 500 Index of stocks declined approximately 3.2 percent.¹⁵ Global stock markets (excluding the U.S.) declined approximately 6 percent.¹⁶ The 10-year Treasury rate declined from 2.27 percent to 1.82 percent.¹⁷ The price of oil declined from \$37.13 per barrel to \$34.39.¹⁸ The U.S. dollar exchange rate versus the yen moved from 120.38 yen/dollar to 113.17.¹⁹ In that period, China devalued its currency. Investment-grade and high-yield credit spreads widened.

Suffice it to say that global financial conditions have tightened. This tightening is likely to have had a restraining impact on the underlying pace of economic activity akin to some level of increase in the fed funds rate.

One obvious question is the extent to which a decline in the S&P is reflective of meaningfully weaker economic conditions in the U.S. In assessing this question, it is worth noting that the S&P is not the same as the U.S. economy. In particular, S&P 500 firms derive about 38 percent of their revenue²⁰ and as much as 50 percent²¹ of their earnings from outside the U.S., while only about 11 percent of U.S. GDP is derived from exports.²² The S&P decline may suggest weaker expectations among market participants for corporate earnings due to slowing global growth and wider credit spreads as well as a stronger dollar. It may also reflect some level of normal and healthy market revaluation.

On the positive side, lower oil prices and a stronger dollar should benefit the U.S. consumer. Due to a strong consumer, my own expectation is that the U.S. economy will likely be resilient in 2016. Having said that, I believe that recent developments call for patience and further diligence in assessing the impacts of slowing global growth and tighter financial conditions on the U.S. economy.

In addition, I am also closely monitoring the impact of key secular trends relating to high levels of debt and aging demographics in the United States and other major economies, including Europe, Japan and China. These secular factors could create downward pressure on potential growth rates and, all things being equal, tend to lower the so-called "neutral" rate, the interest rate at which the Fed is neither restrictive nor accommodative.

While I believe that excessive accommodation carries a cost in terms of distortions and imbalances in hiring, asset allocation and investment decisions, I also believe that, at this

juncture, the Fed needs to show patience in decisions to remove accommodation. Again, this is particularly true in light of key global secular trends as well as recent developments relating to slowing global economic growth and tightening financial conditions.

I believe that the Fed should avoid having a predetermined mindset regarding the path of policy. This path should be driven by our ongoing analyses of cyclical as well as secular trends.

I think it makes sense to emphasize that, at this juncture, monetary policy remains accommodative; although I would note again that policy is somewhat less accommodative than it was on January 1 in light of tightening global financial conditions.

Lastly, I would emphasize that monetary policy should serve as an element of overall economic policy. It is not designed to act in isolation or as a substitute for fiscal policy or structural reforms. There are limits to the potential impacts of monetary policy.

The broad domestic secular challenges of an aging population, access to education and health care, underinvestment in infrastructure, high levels of debt to GDP, and projected stresses on our ability to meet future obligations for retirement and medical benefits are all examples of issues that may affect the long-run path of sustainable economic growth. While monetary policy has a critical role to play in promoting good economic performance and price stability, it has limitations in being able to address these longer-run issues.

Now, I would be very happy to take your questions.

Notes

¹ Each Federal Reserve Bank gathers anecdotal information on current economic conditions in its district through reports from Bank and branch directors and interviews with key business contacts, economists, market experts and other sources. The Beige Book summarizes this information by district and sector.

² Short-Term Energy Outlook, Energy Information Administration (EIA), February 2016.

³ See note 2.

⁴ See note 2.

⁵ See note 2; includes calculations by Federal Reserve Bank of Dallas economists.

⁶ Bureau of Labor Statistics (BLS), Texas Workforce Commission and Dallas Fed.

⁷ See note 6.

⁸ See note 6.

⁹ See note 6.

¹⁰ Bureau of Economic Analysis (BEA). The share of mining averaged 9.6 percent in 2015 (the data go through third quarter 2015). The third-quarter reading was 8.77 percent, and the first and second quarters were both 9.99 percent.

¹¹ "National Income and Product Accounts, Gross Domestic Product: Fourth Quarter and Annual 2015 (Second Estimate)," BEA, Feb. 26, 2016.

¹² "The Employment Situation—January 2016," BLS, Feb. 5, 2016.

¹³ BLS, household employment data, Table A-1, www.bls.gov/webapps/legacy/cpsatab1.htm.

¹⁴ Consensus Economics monthly report, February 2016.

¹⁵ *Wall Street Journal* data.

¹⁶ Based on the Dow Jones Global ex.-U.S. Total Stock Market Index.

¹⁷ Bloomberg data.

¹⁸ Department of Energy data.

¹⁹ Bloomberg data, Tokyo composite.

²⁰ S&P Capital IQ data, weighted by market capitalization, fiscal year 2014; reporting companies.

²¹ “Yardeni: No U.S. Recession in Sight,” by Leslie P. Norton, *Barron’s*, Feb. 6, 2015, www.barrons.com/articles/yardeni-no-u-s-recession-in-sight-1454736560?mod=yahobarrons&ru=yahoo.

²² BEA, February 2016; Trade in Value Added (TiVA) database, Organization for Economic Cooperation and Development and World Trade Organization, October 2015; calculations by the Dallas Fed.