



## The Value of Patience

Robert S. Kaplan

February 05, 2019

In the January 2019 meeting, the Federal Open Market Committee (FOMC) left the federal funds rate unchanged in a range of 2.25 to 2.5 percent and communicated that it “will be patient” as it determines what future adjustments to the target range for the federal funds rate may be appropriate.

The FOMC also issued a “Statement Regarding Monetary Policy Implementation and Balance Sheet Normalization,” which reflects our decision to continue to implement monetary policy in a regime in which control over the level of the federal funds rate is exercised via a so-called “floor system” with an ample supply of reserves.[1] The Committee also said that it is prepared to adjust any of the details for completing balance sheet normalization in light of economic and financial developments.

The FOMC began the process of gradually reducing the size of its balance sheet in the fall of 2017. Through January, the Fed has reduced its balance sheet by approximately \$400 billion.

### Overview

The U.S. economy, as measured by real gross domestic product (GDP), is estimated to have grown approximately 3 percent in 2018. However, various economic and financial uncertainties have emerged over the past several months. I believe that these developments merit close monitoring—and have the potential to impact the economic outlook.

After approximately 115 months of economic expansion and nine federal funds rate increases over the past three years, I believe that we are at a critical juncture in terms of monetary policy. It is my view that the Fed should be exhibiting patience. In particular, I believe that we should take no further action on the federal funds rate until there is greater clarity regarding a number of uncertainties relating to the economic outlook and development of financial conditions.

In addition, consistent with our January “Statement Regarding Monetary Policy Implementation and Balance Sheet Normalization,” I believe it is highly appropriate for us to be open to adjusting the details of our normalization plans based on our ongoing assessments of the economic outlook and financial conditions. My FOMC colleagues and I will continue to analyze and discuss the appropriate size and composition of the balance sheet—and will be working toward making decisions on these issues over the coming months.

### Economic Conditions

U.S. economic growth in 2018 was aided by sizable fiscal stimulus and strong consumer spending. Additionally, for much of the year, business fixed investment and solid global growth provided tailwinds to U.S. GDP growth.

Federal Reserve Bank of Dallas, 2200 N. Pearl St., Dallas, Texas 75201 | 214.922.6000 or 800.333.4460

Based on underlying employment data as well as discussions with business contacts, it is my view that the U.S. labor market is extremely tight by historical standards. The unemployment rate in December was 3.9 percent, and the U-6 rate was 7.6 percent. This U-6 reading was lower than the prerecession low of 7.9 percent in 2006 (U-6 comprises the unemployed, plus “marginally attached workers” who indicate that they would like a job but have stopped looking for one, plus people working part time who would prefer to work full time).

In January, the unemployment rate increased to 4.0 percent, and U-6 jumped to 8.1 percent. The labor force participation rate increased to 63.2 percent. Dallas Fed economists have cautioned that the January increase in the unemployment rate and the substantial rise in U-6 were likely influenced by the partial federal government shutdown and may well reverse in the coming months. In particular, we would note the unusual jump in the number of people working part time who would prefer to work full time; this measure increased by approximately 500,000 and may reflect, at least in part, government workers and contractors seeking alternative employment during the shutdown.

I believe that the Federal Reserve is meeting its inflation mandate. The most recent reading of the Dallas Fed Trimmed Mean, our preferred measure of core inflation, was approximately 2 percent for the 12 months ending in November. This measure, which exes out extreme price movements to the upside and downside, provides a reliable gauge of underlying inflation trends. Given the tightness in the labor market, it is noteworthy that core inflation has not risen more sharply.

My own view is that the structural forces of automation and technology-enabled disruption as well as globalization are limiting the pricing power of businesses and having a dampening effect on inflation. It is also my view that while cyclical inflationary pressures have been building due to a tightening labor market, the impact of these structural forces is also intensifying. Based on these cross-currents, I expect inflationary pressures to remain somewhat muted; I don't expect inflation to run away from us.

## Cautionary Signs and Uncertainties

As we begin 2019, I see several cautionary signs that bear close scrutiny. First, global growth is decelerating. For example, China's purchasing managers indexes have continued to weaken, and the European Central Bank has continued to downgrade its projections for economic growth in the euro zone for 2019. While the world economy (excluding the U.S.) grew 3.4 percent in 2017, growth is estimated to have declined to 3.0 percent in 2018 and is expected to further decline to 2.7 percent in 2019.[2] Measures of world export growth and industrial production (excluding the U.S.) also decelerated during 2018.

It is my view that slowing economic growth outside the U.S. has the potential to ultimately spill over into economic growth in the U.S. I am particularly mindful of the fact that approximately 45 percent of S&P 500 company revenues come from outside the United States and that a variety of U.S. industries rely heavily on exports to China, Europe and other regions of the world. Slower economic growth outside the U.S. means that there is less foreign demand for goods and services originating in the U.S. In addition, a substantial number of U.S. companies are highly reliant on global logistics and supply-chain arrangements. If those arrangements are more uncertain due to trade tensions, this can create challenges for domestic firms in managing profit margins and have a chilling effect on capital spending plans by these firms.

In the U.S., interest-sensitive industries are showing signs of weakness. As of November, new single-family building permits were down 4.3 percent from their February 2018 expansion peak. Sales of existing single-family homes, which hit 5.05 million in November 2017, were down 11.9 percent to 4.45 million as of December 2018.

Recent national and regional surveys of manufacturing activity also indicate signs of slowing. The Institute for Supply Management manufacturing index indicated meaningfully slower growth in December and, to a lesser extent, January. This slowing was also reflected in Federal Reserve Bank surveys from the Dallas, Kansas City, New York and Richmond regions.

In addition, recent surveys of consumer sentiment have fallen. In January, the Conference Board Consumer Confidence Index fell to its lowest level since July 2017, and the University of Michigan Consumer Sentiment Index declined to its lowest level since October 2016, attributed in part to concerns about the partial federal government shutdown.

It is the view of our economists at the Dallas Fed that the negative impact of the recent shutdown on economic activity and unemployment should substantially reverse in the coming months—this, of course, assumes the shutdown does not resume in the coming weeks. Our judgment doesn't take into account any heightening of business and consumer uncertainty that might persist as a result of the shutdown.

Since early October, financial conditions in the U.S. have tightened. For example, high-yield spreads increased from approximately 3.15 percent to 5.30 percent between early October and December 31, and then retraced somewhat to approximately 4.40 percent by January 31. U.S. high-yield corporate bond issuance declined 39 percent in 2018. The average level of monthly high-yield issuance was approximately \$16.9 billion through October 2018 but declined to \$3.6 billion in November and \$0.6 billion in December before rebounding to approximately \$19.9 billion in January.

For the past year, Dallas Fed economists have expected that 2019 growth would slow from 2018 levels. We expected this slowing due to waning fiscal stimulus heading into 2019 as well as the impact of Federal Reserve rate increases that tend to impact the economy with a lag. We have also highlighted the powerful structural headwinds of slowing workforce growth due to aging of the population as well as sluggish productivity growth due in part to lagging education and skill levels in the U.S.

Since early December, Dallas Fed economists have lowered our base-case forecast for 2019 GDP growth to approximately 2 percent. Of course, we are cognizant of ongoing risks to this outlook that include trade tensions as well as the other uncertainties discussed earlier.

## Implications for Monetary Policy

I believe the Federal Reserve has made good progress in achieving its dual-mandate objectives of maximum sustainable employment and price stability. In addition, we have made progress in normalizing monetary policy and in reducing the size of our balance sheet.

I am mindful of the fact that GDP growth is made up of growth in the workforce plus growth in productivity. The current economic expansion has now lasted for nearly 10 years, and we are likely somewhat late in the business cycle, with relatively less spare labor-force capacity to help support continued robust growth.

I believe that the Treasury yield curve is sending cautionary signals regarding expectations for medium- and longer-term GDP growth. These sluggish expectations are reflective of key structural headwinds discussed in this as well as previous essays, which include: 1) aging-population demographics that are likely creating slower workforce growth, 2) limited improvements in productivity growth due in part to lagging education and skill levels in the U.S., and 3) high levels of corporate and federal government debt in the U.S. that are stimulative on the way up but can create impediments to growth if debt levels need to be moderated. Further, it is our view at the Dallas Fed that globalization is likely an opportunity to achieve higher levels of economic growth and that some resolution of current trade tensions is critical to seizing this opportunity.

## The Value of Patience

Based on these various factors, and in light of the uncertainties described in this note, I believe it would be prudent for the Fed to exercise patience and refrain from taking further action on the federal funds rate until the economic outlook becomes somewhat clearer. I expect we will get some further clarity during the first half of 2019.

In addition, it is my expectation that inflation readings will remain somewhat muted in 2019. As I mentioned earlier, it is my view that the structural forces of automation, technology-enabled disruption and globalization will continue to offset, at least in part, the cyclical pressures created by a historically tight labor market. As a result, I believe the Fed has the luxury of being patient over the next several months. Exercising patience will be critical if we are to achieve our dual-mandate objectives of maximum sustainable employment and price stability.

---

### Notes

1. “The Committee intends to continue to implement monetary policy in a regime in which an ample supply of reserves ensures that control over the level of the federal funds rate and other short-term interest rates is exercised primarily through the setting of the Federal Reserve’s administered rates, and in which active management of the supply of reserves is not required,” quote from the “Statement Regarding Monetary Policy Implementation and Balance Sheet Normalization,” Board of Governors of the Federal Reserve System, Jan. 30, 2019.
2. See the Database of Global Economic Indicators, Haver Analytics, Consensus Forecasts. Calculations are based on a representative sample of 40 countries, aggregated using U.S. trade weights. Observed growth uses quarterly data, while forecasts are of annual growth.

### About the Author

Robert S. Kaplan is president and CEO of the Federal Reserve Bank of Dallas.

### From the Author

I would like to acknowledge the contributions of Tyler Atkinson, Jill Cetina, Jennifer Chamberlain, Jim Dolmas, Marc Giannoni, James Hoard, Evan Koenig, Pia Orrenius, William Simmons, Kathy Thacker, Joe Tracy, Mark Wynne and Mine Yücel in preparing these remarks.

---

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

---

Economic Conditions | Essay | Monetary Policy