Monetary Policy and US Economic Outcomes

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On 10 March 2015, Chatham House's US Project hosted a breakfast discussion introduced by Dr Donald Kohn, senior fellow in the Economic Studies Program at the Brookings Institution and former vice-chairman of the US Federal Reserve. This is part of an ongoing project, sponsored by Bank of America Merrill Lynch, which brings together senior representatives from multiple sectors to discuss US and European perspectives on common economic challenges. The conversation, among 27 participants, was conducted under the Chatham House Rule of non-attribution.

After Dr Kohn’s introduction, the broader discussion covered the following main points:

- The US is growing at approximately 2.5 per cent a year. The growth of private demand and household spending (resulting from higher employment numbers rather than wage increases), greater business investment, a relaxation of fiscal restraint and easier access to credit all suggest that this trend will continue. At the same time, US growth is hampered by a disappointing housing rebound and by slowing growth in the rest of the world, along with a much stronger dollar. Net exports are sluggish but only have a limited impact as they account for approximately 15 per cent of GDP.

**The labour market**

- The unemployment rate is low and decreasing, having fallen from 5.75 per cent in December 2014 to 5.5 per cent in February 2015. The labour participation rate has been stable since the spring of 2014, meaning that these are real decreases in the number of people unable to find work. Broader indicators of employment, such as the number of vacancies and turnover rates, are also positive.

- Labour productivity growth was stagnant in 2014, in contrast to the pre-crisis years when it reached 2.5 per cent per annum. The reasons for this are partly cyclical – capital investment was low until last year – and partly due to the slowing pace of technological advancement, which in the 1990s produced a significant number of labour-saving devices but has subsequently had a more limited impact on productivity.

- Inflation has become increasingly unresponsive to changes in the unemployment rate, owing in part to very well anchored inflation expectations – at least as measured through surveys – which means that rising employment is now having a more limited effect on wages and prices.

- There appears to still be some slack in the labour market (as indicated by measures such as stagnant wages and flat labour force participation, and by the still large number of people working part-time who would like full-time employment, even though the low unemployment numbers suggest otherwise). Stagnant wages may be a delayed reaction to the downturn in 2008, and Walmart’s recent pay rise for bottom-end salaries suggests pressure on the labour market is growing.

**The Federal Reserve**

- The inflation rate is currently well below 2 per cent per year and shows little sign of rising, despite the strong labour market.

- There is little certainty about how interest rates will behave in the future. Although the Fed will want the option of raising rates in June, it will also be cautious. Members of the Federal Open Market Committee (FOMC) will look beyond the temporary effect of low oil prices in restraining inflation. However, they need to be ‘reasonably confident’ about the inflation outlook before tightening monetary
policy, as they have said that inflation will return to the 2 percent target over the medium term. Underlying inflation and inflation expectations are likely to have to be stable before the FOMC acts. Some FOMC members would also like to see wages rise more rapidly first.

- The Fed has currently projected that the federal funds rate eventually will get to 3.75 per cent, but markets are predicting 2.5 per cent; the latter may reflect pessimism about long-term growth, which may dissipate as capital investment and wages increase. Equally, however, permanent growth rates may simply remain lower from now on, especially if productivity fails to rise. It is still unclear why the economic recovery was so weak, but if the causes were endemic rather than temporary, future growth may not reach late 20th-century levels.

- The Fed is practicing risk management, exercising caution because tightening too soon and too fast would be harder to correct and have graver consequences than acting too late.

- Communication is vital in conditioning markets. The language of an announcement should focus on what will shape the rate increase trajectory. Rather than being time-specific, it should emphasize that changes will occur in response to economic conditions.

Other

- Congressional oversight of the Federal Reserve is likely to increase in the near future, possibly due to widespread fears that long-term expansionary policy has distorted credit and asset markets. These are legitimate concerns but volatility – a more worrying phenomenon – remains low.

- The dollar is likely to appreciate further, but not to an extent that would have a major impact on imports and prices.

- Macroprudential fixes in the US have been largely structural, focusing on stringent stress tests to banks, rather than counter-cyclical as in the UK. The US financial sector is much stronger than in 2008, but its weaknesses have certainly not been entirely fixed, especially as activity is moving away from banks to less regulated institutions.