DALLASFED Economic Update
National

We Have Liftoff

December 17, 2015

Economic data released since early November point to moderate U.S. economic growth in the fourth quarter. An upward revision to third-quarter real gross domestic product (GDP), coupled with several generally positive reports on October and November economic activity, implied that growth has picked up in the fourth quarter. Evidently, the Federal Open Market Committee (FOMC) has seen enough improvement in the labor market and is reasonably confident that inflation will move up to its 2 percent target over the medium term to raise the federal funds rate for the first time in nearly a decade.

Output Growth Revised Upward

U.S. real GDP expanded at a 2.1 percent pace in the third quarter (*Chart 1*). The second estimate of GDP growth marked an upward revision from the original estimate of 1.5 percent. The revision was mostly due to a 0.8 percentage point increase in the contribution from private inventories—a volatile component.

Recent data from the Institute for Supply Management suggest that the service sector continued to expand in October and November, while the manufacturing sector dipped into contractionary territory in November (*Chart 2*).

Oil prices fell below $40 per barrel after the Organization of Petroleum Exporting Countries' (OPEC) decision on Dec. 4 to maintain current production levels. The drop in oil prices will likely stall oil-related investments, putting downward pressure on the nonresidential fixed investment component of GDP, while boosting private consumption due to increased disposable income (*Chart 3*). The strong dollar and the slowdown in global growth will continue to weigh negatively on U.S. manufacturing and net exports.

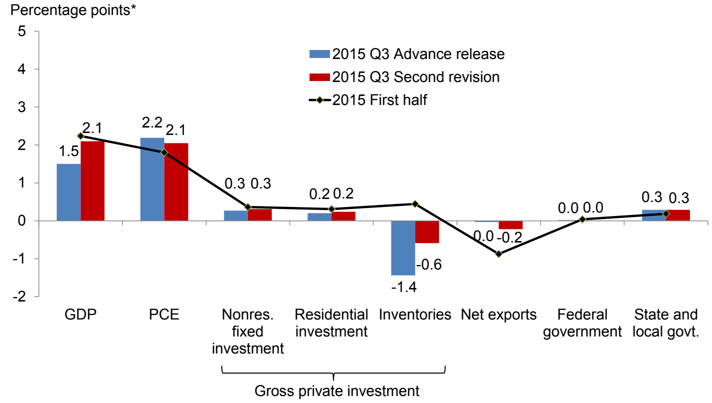
Labor Market Rebounds in Fourth Quarter

Recent reports from the Bureau of Labor Statistics indicate a pickup in job growth in the fourth quarter. In 2015, nonfarm payroll growth has averaged 210,000 per month (Chart 4). Nonfarm payrolls rose a strong 298,000 in October and 211,000 in November after slow payroll gains in August and September. In addition, the establishment survey reported slight increases in average weekly hours and average hourly earnings of production and nonsupervisory workers since September. The headline unemployment rate fell 0.1 percentage points from September to 5.0 percent in November.

Consumer Price Index Inflation Firming

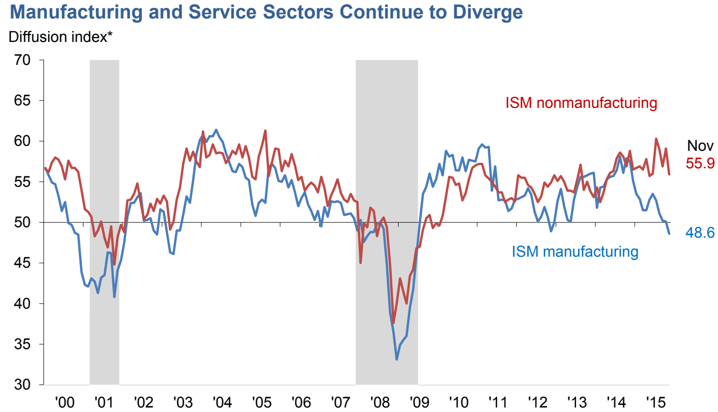
In contrast with the strong employment data, inflation readings have been more mixed on the progress toward the Federal Reserve's 2 percent objective. Core measures of inflation continued to show varying degrees of stability in the personal consumption expenditures (PCE) price index but modest acceleration in the consumer price index (CPI). Chart 5 plots the conventional ex-food-and-energy core measure, along with alternatives produced by the Federal Reserve Banks of Cleveland and Atlanta and the Dallas Fed's Trimmed Mean PCE. Core and trimmed mean measures of PCE inflation over 12 months were 1.3 and 1.7 percent, respectively, while core measures of CPI inflation range from 2.0 to 2.5 percent. The acceleration present in the CPI-based measures, but absent in the PCE-based measures, reflects the greater weight CPI places on shelter costs, which have increased noticeably over the past year.

Chart 1
Third-Quarter Real GDP Growth Revised Upward



*Contribution to percent change in real gross domestic product growth; quarter/quarter, seasonally adjusted annualized rate.
SOURCE: Bureau of Economic Analysis.

Chart 2
Manufacturing and Service Sectors Continue to Diverge



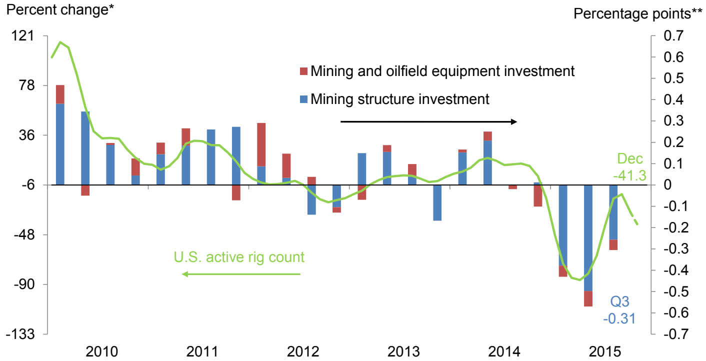
*50+ = economic expansion.
NOTE: Shaded areas indicate recession.
SOURCES: Institute for Supply Management; National Bureau of Economic Research.

The headline unemployment rate has dipped below the Congressional Budget Office's 5.1 percent estimate of nonaccelerating inflation rate of unemployment (NAIRU). While slack in the labor market may remain, an unemployment rate persistently below the NAIRU should, in theory, result in a pickup in inflation.

Forecasters Today Disagree Less on Path of Federal Funds Rate than in Previous Liftoffs

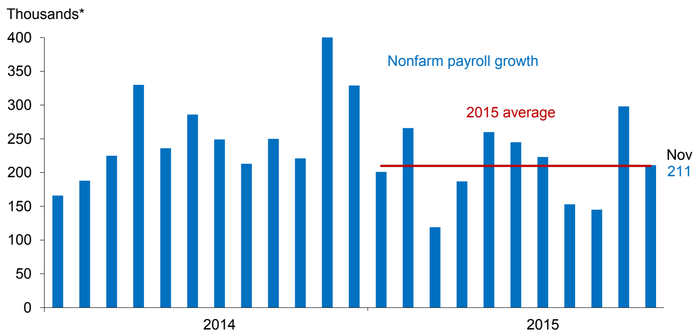
The target range for the federal funds rate has been raised to 0.25–0.5 percent after nearly seven years of being kept around

Chart 3
Recent Drop in Oil Prices May Subdue Oil-Related Investment Again



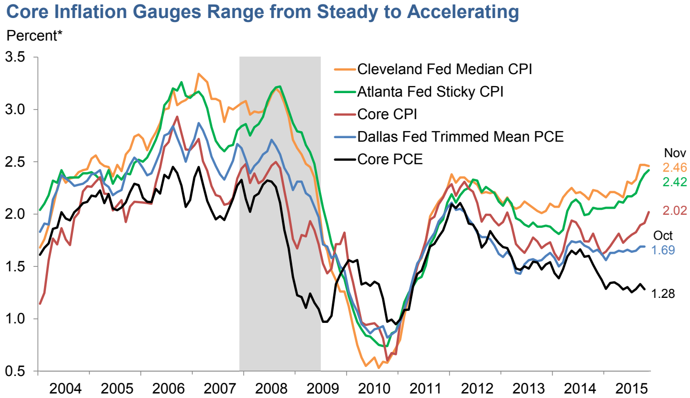
*Three-month percent change of the three-month moving average; annualized rate.
**Contribution to percent change in real gross domestic product growth; quarter/quarter, seasonally adjusted annualized rate.
NOTE: The December average is as of Dec. 11, 2015.
SOURCES: Baker Hughes; Bureau of Economic Analysis; author's calculations.

Chart 4
Nonfarm Job Growth Picks Up



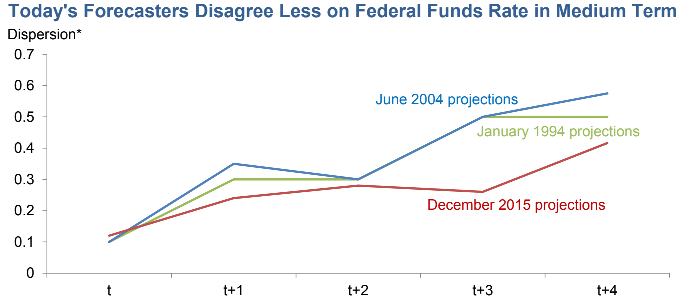
*Seasonally adjusted month-over-month growth.
SOURCE: Bureau of Labor Statistics.

Chart 5
Core Inflation Gauges Range from Steady to Accelerating



*Seasonally adjusted, 12-month percent change.
NOTE: Shaded area indicates recession.
SOURCES: Bureau of Economic Analysis; Bureau of Labor Statistics; Federal Reserve Banks of Atlanta, Cleveland and Dallas; National Bureau of Economic Research.

Chart 6
Today's Forecasters Disagree Less on Federal Funds Rate in Medium Term



*Dispersion is the difference between the 75th percentile and the 25th percentile of the projections.
NOTES: The projections are from the issue of the Blue Chip Financial Forecasts published right before the first liftoff of the federal funds target rate following a recession. Time t is Q3:2004 for June 2004 projections, Q1:2016 for December 2015 projections, and Q1:1994 for January 1994 projections.
SOURCES: Blue Chip Financial Forecasts; author's calculations.

0–0.25 percent. The Federal Reserve reduced this short-term interest rate to near zero following the 2007 financial crisis to help households and businesses finance new spending. In its statement released on Dec. 16, the Federal Reserve "judges that there has been considerable improvement in labor market conditions this year, and it is reasonably confident that inflation will rise, over the medium term, to its 2 percent objective."

In recent years, the Federal Reserve has actively utilized forward guidance as a policy tool to signal households, businesses and investors about future monetary policy. In short, forward guidance relays to the public what the Federal Reserve intends to do and what conditions will lead to a change in its approach. In an exercise, I compare the level of disagreement regarding the path of the federal funds rate among private sector forecasts right before the Federal Reserve raised rates following the last three recessions (*Chart 6*).[1] Private-sector forecasters share similar levels of disagreement for the quarter that follows a federal funds rate hike in all three instances; however, in the medium term, forecasters in December 2015 have less disagreement about the future movement of the federal funds rate than they did in 1994 and 2004. A similar trend appears in the levels of disagreement in the Survey of Professional Forecaster's projections on three-month treasury bills, which should closely follow expectations for the federal funds rate.

There are several possible reasons for less disagreement. Professional forecasters in second quarter 2004 and fourth quarter 2015 shared similar levels of disagreement about the future of the economy (as indicated by projections of unemployment rate). Despite this, today's forecasters have less disagreement about the federal funds rate in a similar forward-looking economic environment. This may be due to the Federal Reserve being more effective in its forward guidance and clearer in its communication to the public on expectations of future monetary policy. Another possibility is that the private sector today may have a better understanding of the models the Federal Reserve uses to guide its policies since the last two recessions. Though forecasters may have less disagreement about the path of the federal funds rate, exiting a zero interest rate environment is still uncharted territory in U.S. monetary policy.

—Daniel Lin

Note

1. The past three recessions lasted from July 1990 to March 1991, March 2001 to November 2001, and December 2007 to June 2009. The first federal funds rate hike after each recession occurred in February 1994, June 2004 and December 2015.

About the Author

Lin is a research analyst in the Research Department at the Federal Reserve Bank of Dallas.