United States

If labour was the only criterion…

■ **Janet Yellen made note of the financial market turmoil, but sought to put it into perspective while highlighting the dynamic job market.**

■ **The Fed maintains its analysis: growth will remain strong enough to absorb residual underemployment while inflation will gradually return towards the Fed's 2% target. Global growth trends are the main downside risk to this scenario.**

■ **The Fed does not seem to have changed its plans. By reiterating that its decisions are data-dependent, Ms. Yellen did not close the door on any options for the March FOMC meeting. So will the Fed raise its key rates or not?**

Fed Chair Janet L. Yellen spoke this week before the Congressional financial committees of both houses[1]. This long-awaited speech was the first time she had spoken since the press conference following December's rate increase, and since the financial market turmoil of early 2016.

Ms. Yellen's opening statements did not suggest a paradigm shift: the Fed continues to expect that growth will be strong enough to absorb residual underemployment and that inflation will return towards its 2% target in the medium term. The exceptional factors of low energy prices and the dollar's appreciation would gradually put less of a strain on inflation trends, which are also likely to get support from the dynamic job market. This has been the Fed's analysis for several months, and there is nothing new about the downside risks to this "ideal" scenario either. Indeed, global growth trends are the main risk factor.

Yet Ms. Yellen's speech did not overlook the turmoil in the financial markets. Still, the main downward risk on her outlook is about the external environment. She spent more time spelling out the chain of events that could end up undermining the US recovery rather than the factors likely to fuel stronger growth (i.e. support from low oil prices). Yet she also put into perspective the tightening of financial conditions caused by the equity market correction, wider corporate spreads and the strong dollar, which could undermine growth prospects if it were to persist. Ms. Yellen noted that low long-term rates and oil prices could also be expected to provide support.

Ms. Yellen's speech leaves the impression that the Fed has not revised its intentions to continue gradually normalising monetary policy – at least not yet. By restating that the Fed's decisions would remain data-depend and that the Fed would keep on closely monitoring "measures of labour market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments". Ms. Yellen did not close the door on any options for the next FOMC meeting, which will be held in just over a month. So, will the Fed raise its key rates or not?

[1] Twice a year, the Fed Chair is testimony before the House Committee on Financial Services and the Senate Committee on Banking, Housing and Urban Affairs. These hearings coincide with the release of the Monetary Policy Report as required by the Humphrey-Hawkins law of 1978.

Tighter financial conditions…

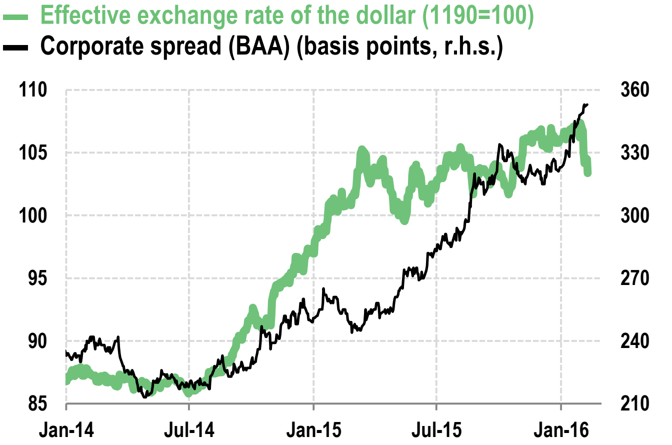

Chart 1 Sources: Bank of England, Federal Reserve

…must be kept in perspective

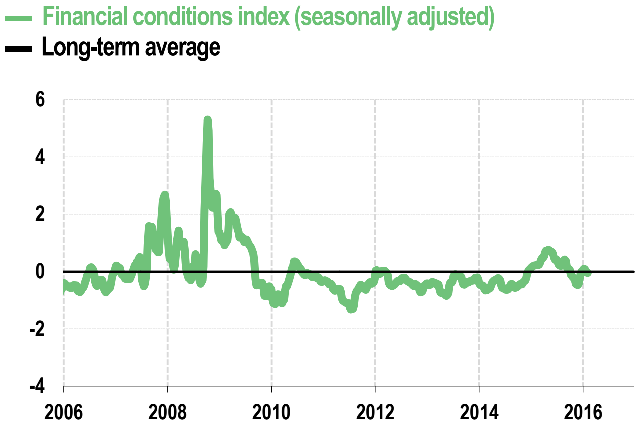

Chart 2 Source: Federal Reserve Bank of Chicago

The labour market conditions clearly support another rate increase. In January, the unemployment rate dropped below 5% (to 4.9%) and wage growth was relatively strong (+0.3% for production and non-supervisory employees). Contrasting with survey data, the manufacturing sector not only added jobs (+29k for the month), but also the number of hours worked increased. The upturn in the index of aggregated hours in January (+0.5%) could foreshadow a rebound in manufacturing activity. Two factors lend credibility to this hypothesis: the strong increase in overtime work (+2.4%) and the "new orders" component of the ISM index (+2.7 points to 51.5, the highest score since summer 2015).

Underemployment also contracted much more sharply, as illustrated by the latest JOLTS data[2]. It is especially worth noting the strong rebound in the quits rate in the private sector (2.4%, the highest rate since summer 2007), which indicates that Americans have regained confidence in the quality of the job market.

Yet the improvement is more far-reaching than just this one statistic, as confirmed by our SLACK index[3] (chart 3). If this measure of underemployment continues to improve at the same pace as over the past three years, it will return within its "normal" fluctuation band by next August and swing into positive territory in fall 2017.

Another measure – which does not focus solely on the current job market situation but also on prospects – paints a very clear picture. The Janet index, a measure we constructed in 2013 to monitor the progress towards the goals set for the third wave of quantitative easing (QE3)[4], has been in positive territory since last November. Under similar conditions in 2004, the Fed began a new monetary tightening phase. In brief, as much if not even more so than in December, current job market conditions continue to justify the normalisation of monetary policy.

Yet there is a big difference between the current situation and the one that prevailed in 2004, and that has nothing to do with financial market volatility. The inflation outlook is not nearly as solid as it was in the earlier period. Weak inflation can certainly be attributed in part to low energy prices and the strong dollar's impact on the prices of imported goods. According to the Monetary Policy Report, the strong dollar could have accounted for a 0.5-point reduction in the year-on-year rate of increase of private consumer expenditure price index (1.4% in December), while the drop-off in oil prices surely had a non-negligible impact as well (though no precise figure was given). If these assumptions are correct, without those temporary factors artificially lowering inflation, the PCE index would currently run above 2%, i.e. at quite the same rate as in summer 2004, when the previous tightening cycle was initiated.

But hypotheses are only hypotheses, and the picture painted by various measures of inflation expectations is much less serene. According to Ms. Yellen, changes in the risk and liquidity premiums could explain the decline in market expectations. Once again, it is hard to be certain, and if the Fed decides to put off another key rate increase, it is more likely to be due to these trends rather than to financial market fluctuations.

[2] The Job Opening and Labor Turnover Survey (JOLTS) looks closely at gross job flows, notably hiring, firing, quits and job openings.
[3] The SLACK index is constructed from the sum of standardised indicators. It is read as the standard deviation from the average. Its components are comprised of the underemployment indicators cited by Ms. Yellen ("What the Federal Reserve is Doing to Promote a Stronger Job Market", 2014 National Interagency Community Reinvestment Conference, Chicago, 31 March 2014): number of employees working fewer hours than they would like, the hiring and quitting rates, the labour force participation ratio for the 25-54 age group, the share of long-term unemployed, and wage trends. See "The truth is out there – or why the falling unemployment rate is late accelerating wages", Alexandra Estiot, BNP Paribas Conjoncture, October-November 2014.
[4] See "Map of their heads", Alexandra Estiot, BNP Paribas Eco Week, April 26th 2013.

Rapid absorption of underemployment

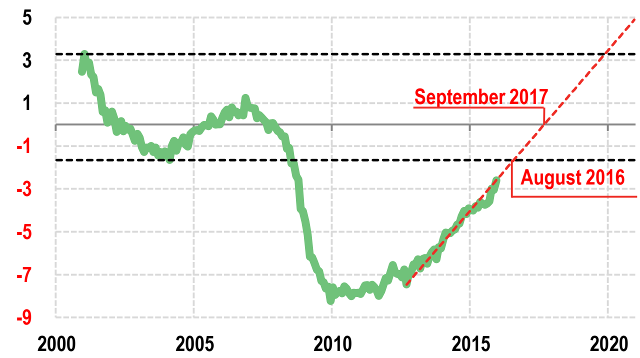

Chart 3 Source: BNP Paribas Economic Research

Normalisation of monetary policy is justified

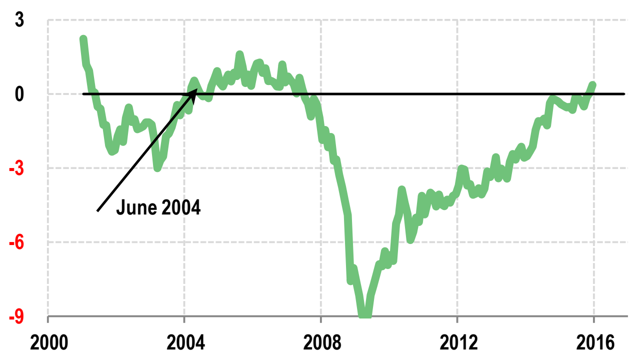

Chart 4 Source: BNP Paribas Economic Research

Disinflation expectations

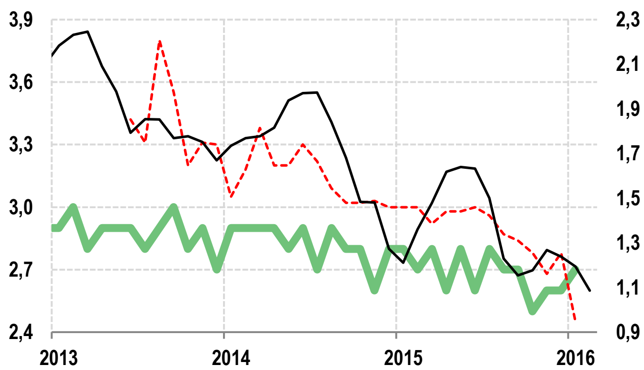

Chart 4 Sources: Federal Reserve, New York Fed, University of Michigan