United States

Potential problem

- **The Fed is clearly concerned about the risks straining US economic prospects.**
- **The world economy is certainly not buoyant, but the US has a very closed economy, and usually, periods of expansion are brought to an end by the interplay of exogenous shocks or too tight a monetary policy.**
- **The Fed is actually concerned because of the asymmetry of risks at the zero lower bound.**
- **As for our own concerns, they are more about the slowdown in the potential rate of growth.**

The Fed decided to take a pause after initiating the process of normalising monetary policy in December 2015. Yet this pause might not be so brief now that the FOMC members expect to make only two key rate increases in 2016. As Janet Yellen confirmed in her opening remarks at the post-meeting press brief, the decision to maintain the monetary status quo reflects "the assessment of the economic outlook and the risks associated with that outlook". The Fed is clearly concerned about the risks straining US economic prospects. The world economy is certainly not buoyant, but the US has a very closed economy, and usually, periods of expansion are brought to an end by the interplay of internal factors (a restrictive policy mix; excesses that need to be corrected) or exogenous shocks (notably oil prices), which by nature are unpredictable. So what exactly is the Fed so worried about?

A closed economy

In March, the FOMC statement left no room for doubt: "global economic and financial developments continue to pose risks." Indeed, it is hard to find a region in the world boasting buoyant growth. Yet in the past, foreign trade has been neither the driving force nor a damper for the US economy. In volume terms, exports accounted for less than 13% of GDP in 2015, compared to nearly 72% for household spending. The US economy's degree of openness, as measured by the sum of exports and imports over GDP, is among the lowest of the developed countries, at 29% in 2015, compared to 62% for France and 90% for Germany. As a corollary, the manufacturing sector has a relative small weighting in the US economy, whether measured in terms of production (12.1% in 2015) or payroll employment (8.7%).

The global economy is clearly slowing, as confirmed a few weeks ago by the decline in greenhouse gas emissions, which unfortunately cannot be attributed entirely to the boom in renewable energy sources. Even so, the export performances of US companies are still relatively solid, especially considering they have had to cope with a strong and rapid upturn in the dollar. Export growth remained in positive territory in 2015, only slowing somewhat to +1.1%, after averaging 3.2% over the three previous years.

Steady growth

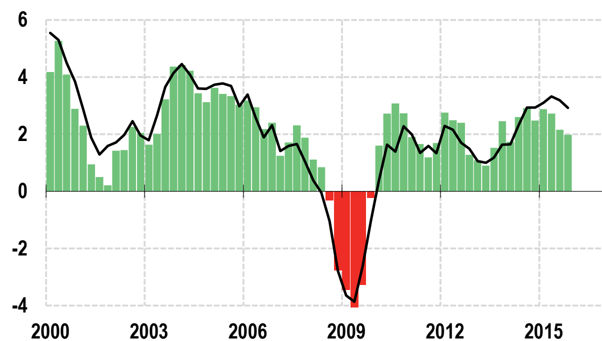


Chart 1 Source: US Bureau of Economic Analysis

Of course, we cannot cry victory based on these recent performances because currency appreciation tends to have lagging effects. Plus the Fed's policy is not dictated by past performances as much as by future prospects. Yet we cannot ignore several reassuring factors either. First there is the rebound in oil prices, which should bring the commodity exporting countries some relief. Second, the stabilisation of the dollar benefits not only US exporters, but also the emerging countries that have dollar-denominated debt and those whose currencies are more or less pegged to the dollar. Another reassuring factor is the rebound in the US manufacturing sector, which the various ISM and regional Fed surveys seem to confirm.

As employment goes, so goes the economy

The outlook for domestic demand hinges above all on the strength of the job market, which is a key determinant of disposable household income. Here there is reason for optimism: after stalling briefly in January, job creations picked up again in February and March, at a monthly rate of more than 200,000 jobs. Moreover, wages continue to trend upwards, even though the acceleration is still mild given the low level of unemployment (5.0% in March). Public finances are no longer restricting growth, as illustrated by the number of public-sector jobs and spending, which are no longer contracting.

If there are any risks, they come from the corporate side. Earnings have slacked up. After taxes and adjusted for the inventory valuation and capital consumption, profits were down 5.1% in 2015. Yet this decline must be seen in the light of the 60% growth reported over the previous six years, when they accounted for a record-high share of GDP. The energy sector is also a burden: excluding these activities, corporate earnings would have stagnated rather than declined in the second half of 2015. Finally, full-year growth was still strong at 12.6%, after doubling between 2008 and 2014.

These earnings developments are nonetheless alarming for what they say about investment prospects, notably because debt has soared in recent years. According to Fed data, the debt of non-financial companies, including bank loans and corporate bonds, has increased by nearly 6% a year since 2012, rising from 132% of gross value added to 143% in 2015.

Yet our big concern is not about the increase in debt, which remains below previous peaks, but about how the funds are being used. Fixed investment was only one of several allocations, since US companies continued to give preference to dividend pay outs and share buybacks. Although earnings declined in 2015, dividend payments kept rising, while non-residential investment stagnated at 13.5% of GDP. Figures for net investment, which excludes the replacement of aging facilities, are even less positive. After having been negative in 2009, they increased very slowly to peak at 3.2% in early 2015, before declining to 2.8% thereafter. The same observation can be made even after excluding spending on oil infrastructure. Sluggish investment is a problem, notably in terms of productivity gains. Between 2011 and 2015, labour productivity rose only 0.5% a year, compared to 2.3% a year in the five years preceding the 2007-2009 crisis, and an average of 3.2% over the four years following the 2001 recession.

Stable prospects…

To state the obvious, the risk of a US recession increases day after day because the further one gets from the previous recession, the closer one gets to the next one… The current expansion phase began in July 2009 and has already lasted 26 quarters. The three previous expansion phases lasted 30 quarters (1982 to 1990), 40 quarters (1991 to 2001) and 24 quarters (2001 to 2007). Even so, we would not dare go so far as to try to predict the precise timing of the next contraction phase. Since the early 1970s, recessions have been triggered either by an oil shock or by excessively restrictive monetary policy. It was the excesses in need of correction that dictated the recession's duration and scope. For mild recessions, it was only a matter of cleaning up inventory. It takes much longer to correct excessive investment, while debt crises result in the most deep-felt and long-lasting contractions.

Today, we can hardly talk about excesses. Household debt has fallen to the lowest level in fifteen years, dropping from nearly 130% of disposable income in 2007 to 103% in 2015. As we have seen above, companies are far from having overinvested, and their debt ratios are still about 10 points below the 2009 level. That leaves us with inventory levels. Since spring 2014, inventories have surged, notably in proportion to sales, a trend that began in the wholesale market before spreading to retailing and then the manufacturing sector. Inventory building slowed sharply, which explains at least in part the slowdown in manufacturing output. If the industrial recovery is confirmed in the months ahead, we then will be able to conclude that the US economy has corrected the sole of its excesses.

… but asymmetry of risks

When seen in this light, the risks of recession seem limited, at least as far as a protracted contraction is concerned. Yet the Fed does not have many tools to fight a recession either. This is why we speak about asymmetric risks at the zero lower bound. If growth were to accelerate suddenly, it would only close the output gap more rapidly than expected, generating inflationary pressures that the Fed knows how to cope with. In contrast, another slowdown would be harder to combat, as the central bank is no longer armed with all of its conventional policy tools.

The truth is that we are less worried about recessionary risks in the short term, than we are about potential growth in the medium term. Demographic trends are hampering the increase in available labour; companies are curbing capital expansion; and labour productivity is struggling to remain in positive territory. The output gap is more likely to close at the "wrong end": we are more likely to see sluggish growth potential rather than an acceleration in production.

One consequence of this phenomenon is low interest rates in the long term. The FOMC members are perfectly aware of this, as illustrated by the constant downward revisions of their long-term projections for the Fed funds target rate. This leads us to conclude that the universe of possibilities is shrinking for interest rate policy, especially since the Fed seems to be much more reticent than the other central banks to even consider the feasibility of negative interest rates.

Weak investment

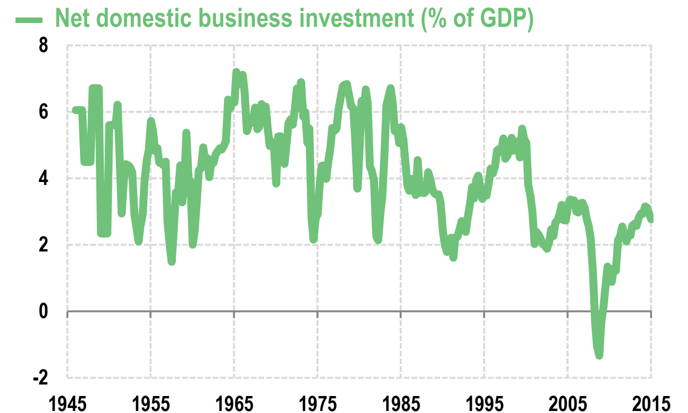
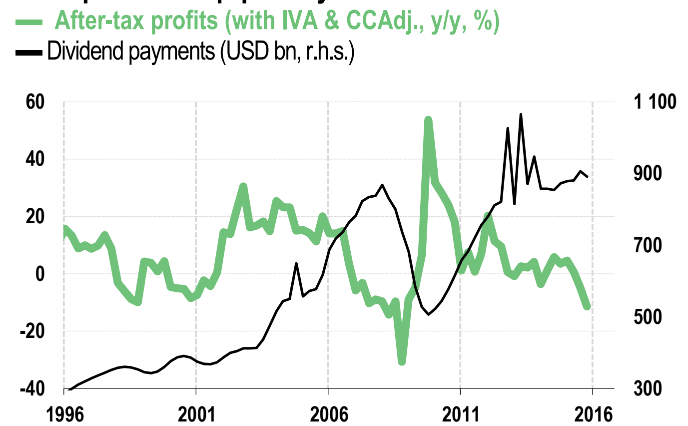


Chart 2 Sources: BEA, Federal Reserve

Corporates' top-priority



Graphique 2 Sources: BEA, Federal Reserve