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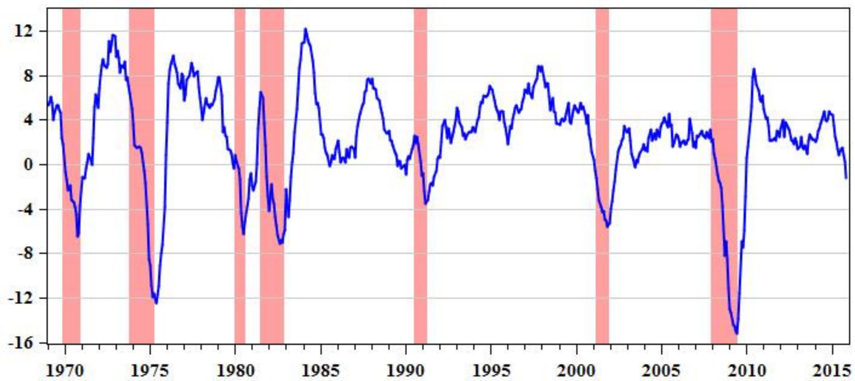
Assessing the Federal Reserve's Economic Assessments

When the Federal Reserve announced in mid-December that it would begin raising short-term interest rates, Fed officials characterized domestic spending as "solid" and the risks to economic growth as "balanced." And they indicated that they were "reasonably confident" that inflation would move back up to the Fed's 2 percent target over the next several years. However, data released over the past few weeks underscore concerns about the economic outlook that were apparent even before the Fed's announcement.

Industrial Production and the Incidence of Recessions



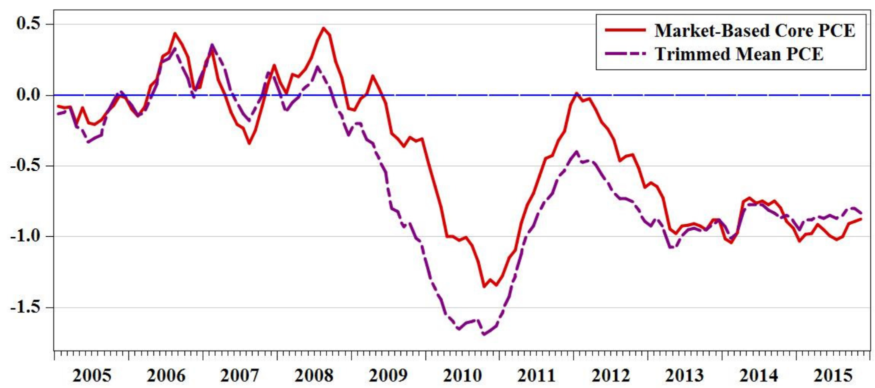
Note: The solid line denotes the 12-month percent change in the Federal Reserve Board's index of industrial production, and the shaded areas denote periods of recession as determined by the National Bureau for Economic Research.

On the same day it announced its monetary policy decision, the Federal Reserve released its latest measure of industrial production. As the chart above shows, the industrial sector *contracted* 1.2 percent in November from a year earlier. That contraction was initially downplayed as largely reflecting the effects of warm weather on utility production. But subsequent data point to a broader and more persistent contraction. In the manufacturing survey published Monday by the Institute of Supply Managers, the index of business conditions declined further in December and now stands at its lowest level since 2009.

Turning to domestic spending, the term "solid" implies substantial strength and resilience. Yet recent indicators paint a gloomier picture. Shipments of core capital goods (that is, nondefense items excluding aircraft) contracted at an annual rate of nearly 2 percent over the three months ending in November. Private non-residential construction contracted about 4 percent. Meanwhile, growth in real personal consumption expenditures dropped from 4 percent last spring to 3 percent over the summer and slowed further, to around 2 percent, over the three months ending in November. In light of those readings, the Atlanta Fed's current "now-cast" analysis indicates that real GDP barely increased during the fourth quarter of 2015.

These data reinforce the view that the U.S. economy may be operating at stall speed. Consequently, the possibility of falling into recession poses a much more significant risk than the prospect of economic overheating. Indeed, as shown in the chart above, *every* episode of contracting industrial output since 1970 has been associated with the onset of a recession. These downside risks make a compelling case for Fed officials to refrain from further monetary tightening and, instead, refocus on contingency planning for scenarios in which such risks materialize.

Persistent Shortfalls of Inflation



Note: The solid line denotes the 12-month change in the market-based price index for core personal consumption expenditures (PCE), as published by the Bureau of Labor Statistics. The dashed line shows the 12-month change in the trimmed mean PCE price index published by the Federal Reserve Bank of Dallas. Each series is shown relative to its average rate in 2005-2007.

The continuing shortfall of inflation is another concerning indicator. The Fed's inflation target is 2 percent, as measured by the price index for personal consumption expenditures. This index rose only 0.4 percent in November from a year earlier—undershooting the Fed's target for the 43rd straight month—partly owing to declining prices of crude oil and non-fuel imports. The chart above depicts two measures of underlying inflation, each of which has been running persistently nearly a percentage point lower than its average in 2005 to 2007, just before the last recession. Moreover, surveys of longer-term inflation expectations have been drifting downward over the past year, suggesting that households and businesses have been losing confidence in the Fed's commitment to its target. That downturn in expectations may well exert further downward pressure on actual inflation.

In retrospect, it is not surprising that, at the time of their December meeting, Fed officials sought to describe economic developments as affirmatively as possible, bolstering the rationale for their decision to initiate the tightening cycle. It would be unfortunate, however, if analysts and investors start doubting the objectivity of the Fed's descriptions of incoming data.

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