US

The meaning of data dependence

Although Federal Open Market Committee (FOMC) members signalled at their last meeting that a rate rise was likely in December, **any increase in interest rates remains data dependent**. For the Federal Reserve (Fed), that essentially means that the economy needs to grow fast enough that the output gap (which is currently around 1.5% of GDP – see Chart 2) continues to close, allowing labour slack to be eroded and underlying inflation to trend back towards the Fed's target. Note that not all components of GDP need to be growing quickly to satisfy this condition – just enough of them and by a sufficient amount for the aggregate economy to grow faster than its potential pace 1.75%.

So, how are things tracking? Let us begin with private consumption, which accounts for 70% of GDP. Real spending in August, the most recent month for which comprehensive data is available, contracted 0.1%, thanks to a large decline in light vehicle sales and a modest decline in core retail sales. Nevertheless, thanks to stronger growth in July, **private consumption is still on track to rise around 2.5% (annualised) in Q3** as long as spending does not contract again in September, which seems unlikely given the pick-up in consumer sentiment, solid underlying pace of household disposable income growth and rebound in vehicle sales.

The biggest drag on economic growth over recent quarters has of course been inventory investment. On that front, the recent news has been good, with partial indicators implying that this should reverse in the third quarter. Housing indicators also suggest that residential investment should be positive in Q3. Housing starts declined in August, but that appeared to mainly reflect disruptive weather in the South and July starts were better. New home sales also dropped in August, though the Q3 average is likely to be well above the average in the previous quarter. Taken together these two indicators suggest that the upward trend in residential investment should continue. Unfortunately, **near-term fixed business investment indicators remain soft**. Core capital goods shipments, which closely track fixed equipment investment in the national accounts, contracted in August, suggesting that component of fixed business investment will be flattish in Q3. Core capital goods orders have been edging up in recent months, and there was a decent rebound in the new order component of the ISM survey, which are both consistent with a modest improvement in equipment investment between now and the end of the year (see Chart 3). Meanwhile, a gradually rising oil rig count and tepid architectural billings imply that non-residential structures investment may stop subtracting from growth in Q3, though substantive positive contributions are unlikely until 2017. Fixed business investment may be tepid but at least exports are returning to some semblance of healthy. Indeed, the real trade deficit has improved meaningfully in recent months, meaning that net exports will make a solid positive contribution to GDP growth in Q3. All in all aggregate **economic growth is not especially rapid, and it is still highly dependent on the consumer, but it is probably fast enough to reduce spare capacity**; and that may be all the Fed needs to resume policy normalisation.

Chart 2: Spare capacity remains

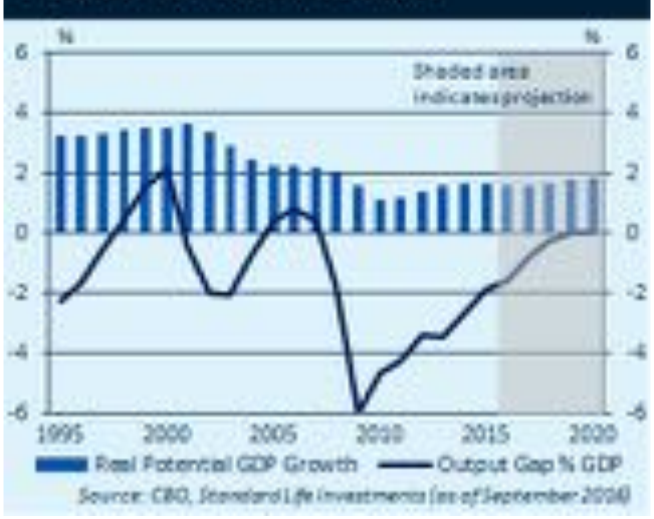

Chart 3: Investment in the doldrums